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## To Be Creditor or To Be Shareholder, That Is the Question: Is the Debt-For-Equity Swap Creditors' Financial Suicide?

Jongho Kim

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# **TO BE CREDITOR OR TO BE SHAREHOLDER, THAT IS THE QUESTION: IS THE DEBT-FOR- EQUITY SWAP CREDITORS’ FINANCIAL SUICIDE?**

JONGHO KIM PH.D & SJD\*

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## I. INTRODUCTION

A company can use private loans or bonds to raise funds from third parties.<sup>1</sup> Private loans can be divided into those received from financial institutions and those received from general individual investors.<sup>2</sup> Capital finance can come from both local and international financial institutions and investors. However, obtaining financing from a third party often causes financial overburdening be-

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<sup>1</sup> See *Honua Sec. Co. v. SMI Hyundai Corp.*, No. 1:10-cv-00785, 2011 WL 9526013 (E.D. Va. Oct. 27, 2011) (showing the facts of loan activity in the Verdict and Settlement Summary).

<sup>2</sup> See e.g., *In re Diamond Alexandria LLC.*, No. 09-10461, 2009 WL 8189288 (Bankr. E.D. Va. Jan. 22, 2009) (stating the Debtor obtained a loan from financial institutions and acquired financing from a group of eleven private investors).



cause of interest rates. In particular, financially troubled companies may face a lack of liquidity and fail to achieve revival.<sup>3</sup> If a company has the ability to revive itself through corporate reorganization, it is recommended to do so through a reorganization plan that provides more favorable repayment conditions.<sup>4</sup> The forms of corporate finance for stock companies vary for civil law and Anglo-Saxon common law systems. In Germany, the leading practitioner of the civil law system, to obtain corporate financing, financial institutions—such as banks—acquire shares and sell them to their clients.<sup>5</sup> Hence, financial institutions play absolute roles in Germany's corporate governance. On the other hand, the United States, an Anglo-Saxon common law practitioner, developed stock exchange markets and mostly issues new stocks and bonds to supply funds. American companies rarely borrow money from banks. Thus, U.S. stock-related laws are more advanced than in other countries as there are various types of stocks and bonds found across the country. In addition, U.S. corporate law is much more flexible compared to that of Germany. The stock exchange market and its corresponding financial institutions, like investment banks, play a large part in the supervision of management. Thus, the law does not need to be as strict as that in civil law systems.

In Korea, bank loans were dominant instead of equity financing obtained through the issuance of new shares.<sup>6</sup> The excessive debt ratio of many companies led them to fall before the Eastern Asia economic crisis at the end of twentieth century, taking with them the financial institutions that were their largest creditors.

If an insolvent company intends to issue new shares to convert loans into investments, it may consider making an in-kind investment using claims and set-off claims and payments. However, an in-kind investment has its own problems. For example, before one uses set-off claims and payments, a determination must be made as to whether such claims are permitted. Article 334 of the Korean Commercial Act (KCA) states “a shareholder may not assert a set-off

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<sup>3</sup> See *U.S. v. Izydore*, 167 F.3d 213 (5th Cir. 1999). Sometimes companies may even resort to financial crimes to overcome the liquidity risk. *Id.*

<sup>4</sup> The basic idea for bankruptcy reorganization law is to inject fuel into the failing company under the Code, which sets forth numerous requirements for confirmation of a plan of reorganization. See *In re Oneida Ltd.*, 351 B.R. 79, 84 (S.D.N.Y. 2006).

<sup>5</sup> *Id.* Germany's Aktiengesetz (Stock Act) allows only promotion of incorporation, substantive incorporation is excluded. Aktiengesetz [AktG] [Stock Corporation Act], Sept. 6, 1965, BGBL. I at 1089, last amended by Gesetz [G], July 23, 2013 BGBL. I at 2586, art. 56 (Ger.), <http://www.gesetze-im-internet.de/aktg/BJNR010890965.html>.

<sup>6</sup> Byung S. Min, *Dynamic prospects for Korean bank's monitoring of business groups*, in *THE KOREAN ECONOMY AT THE CROSSROADS: TRIUMPHS, DIFFICULTIES AND TRIUMPHS AGAIN* 195 (Routledge ed., 2014) (“While equity financing began in 1980s, banks have been the major source of corporate financing.”).

against the company as regards to payment of the subscription price for shares.”<sup>7</sup> The Supreme Court of Korea clearly stated that a set-off between loan obligations to banks and company payments will not be recognized.<sup>8</sup> According to the KCA, setting off loan obligations and payments is prohibited.<sup>9</sup>

This Article deals with debt-for-equity swap-related issues in Korean corporate restructuring procedures. Debt-for-equity swaps were widely employed during the Latin American foreign debt restructuring process,<sup>10</sup> but the Korean case is slightly different. Because the creditors of reorganizing corporations are mainly Korean domestic financial institutions rather than foreign creditors,<sup>11</sup> this type of financial scheme is applied under local law. The following examines the legal aspects of debt-for-equity swaps, which have been promoted as a way to eliminate excessive insolvent loans and financial debts (and stood in the way of restructuring, via IMF bail-out funds). It also discusses how a debt-for-equity swap is handled in the corporate reorganization process.

## II. SIGNIFICANCE OF A DEBT-FOR-EQUITY SWAP IN CORPORATE REORGANIZATIONS

Stock corporations are profit-oriented entities that need enormous capital to maintain business activities. Capital comes directly from the shareholders' investment at the time of incorporation, but afterwards other forms of corporate financing may be needed from time to time.<sup>12</sup> Even companies with sound financial structures cannot avoid insolvency when they fail to supply funds in times of need. They must find stable sources of capital for short to mid-term settlements. This is why fluid corporate finance is the essential and absolute

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<sup>7</sup> Sangbeob [Commercial Act], Act No. 1000, Jan. 20, 1962, *amended by* Act No. 10696, May 23, 2011, art. 174 (S. Kor.), *translated in* Korea Legislation Research Institute Online Database, [http://elaw.klri.re.kr/eng\\_service/main.do](http://elaw.klri.re.kr/eng_service/main.do), also available at <http://unpan1.un.org/intradoc/groups/public/documents/apcity/unpan011485.pdf> (2001 Amendment of the KCA); KOREA SOUTH COMPANY LAW AND REGULATIONS HANDBOOK: STRATEGIC INFORMATION AND BASIC LAWS 92 (2015).

<sup>8</sup> Joon Park & Suhn-Kyoung Hong, *Special Treatment of Derivatives in Korean Insolvency Proceedings: Comparison with the United States and Japan*, 349 J. KOREAN L. 348, 354 no.16. (2008), [http://heinonline.org/HOL/Page?handle=hein.journals/jkorl7&div=23&g\\_sent=1&collection=journals](http://heinonline.org/HOL/Page?handle=hein.journals/jkorl7&div=23&g_sent=1&collection=journals).

<sup>9</sup> *Id.*

<sup>10</sup> Marcela Valente, *Argentina Seeks to Restructure Debt Held by Vulture Funds*, IPS INTER PRESS SERVICE NEWS AGENCY (Aug. 29, 2013) <http://www.ipsnews.net/2013/08/argentina-seeks-to-restructure-debt-held-by-vulture-funds/>.

<sup>11</sup> See Gerald E. Meyerman, *The London Approach and Corporate Debt Restructuring in East Asia*, in MANAGING FINANCIAL AND CORPORATE DISTRESS: LESSONS FROM ASIA 299 (C. Adams et al. eds., 2000).

<sup>12</sup> See STEPHEN A. ROSS ET AL., *ESSENTIALS OF CORPORATE FINANCE* 316 (4th ed. 2004).

premise for a company's survival.

There are several ways a company can obtain financing. Typically, when companies use debt financing they borrow from banks or issue accommodation bills (i.e., commercial paper, bonds, or subordinated debentures).<sup>13</sup> Equity financing involves the issuance of new shares.<sup>14</sup> The company may also consider a merger with a financially stable company.

Companies prefer using their own capital, which is free of interest and does not need to be repaid. Stock companies were originally suited for large-scale management and required large capital accumulation from different sources—a variety of private investors, the public, or both. However, corporate financing via issuance of new stocks and bonds is generally related to huge investors and their interests, and is widely regulated by the Corporation Act and other statutes, including the Stock Exchange Act in Korea.

When the Korean government and companies received the so-called “IMF rescue funds” in late 1997, they were required to undergo financial restructuring to recover the Korean economy's credibility and reputation in the world market.<sup>15</sup> Therefore, the government decided to promote financial restructuring to reduce the debt ratio of the five largest groups of companies<sup>16</sup> to below 200%, while promoting a corporate improvement “workout”<sup>17</sup> for companies between sixth and sixty-fourth conglomerate groups in size.<sup>18</sup> Companies following re-

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<sup>13</sup> See RICHARD T. McDERMOTT, *LEGAL ASPECTS OF CORPORATE FINANCE* 243–45 (2d ed. 1995). Subordinated debentures are debentures where holders receive subordinated dividends rather than becoming general creditors if the debtor goes into bankruptcy. *Id.* In general, subordinated debentures are issued with a high interest rate and a right to convert to shares. *Id.*

<sup>14</sup> Equity can be negative if liability exceeds assets.

<sup>15</sup> See Joongangilbo, *Fund-Raising and Other Financial Facts Comparison at the Time of Asian Financial Crisis*, (Mar. 3, 2001) (citing statistics of The Bank of Korea); see also *infra* app. Table 1.

<sup>16</sup> The Korean competition law, Monopoly Regulation and Fair Trading Act (MRFTA), defines *enterprise group* as:

a group of companies whose businesses are substantially controlled by the same person according to the following distinction pursuant to the standards as prescribed the Presidential Decree: (a) Where the same person is a company, a group composed of such person and one or more companies controlled by him; and (b) Where the same person is not a company, a group composed of two or more companies controlled by him.

See Monopoly Regulation and Fair Trading Act, Act No. 3320, Dec. 31, 1980, *amended* by Act No. 7315, Dec. 31, 2004, art. 2 § 2 (S. Kor.), <http://www.jftc.go.jp/eacpf/01/Korea-monopoly.pdf>.

<sup>17</sup> Here, “a workout refers to a negotiated agreement between the debtors and its creditors outside of the bankruptcy process.” PATRICK A. GAUGHAN, *MERGERS, ACQUISITIONS, AND CORPORATE RESTRUCTURINGS* 449 (2d ed. 1999).

<sup>18</sup> The Korean government used emergency policies such as “big deals” between large companies, release of mutual guarantees, and injection of public funds, with the Korean laws being amended accordingly to receive IMF rescue funds. See Press Release, Korean Ministry of Finance and Economy, *Active Use of Debt for Equity Swap* (Jun. 9, 2001).

vival programs for restructuring had to see viable improvements in satisfying financial conditions. For this purpose, each company had to perform a bold financial restructuring and take active countermeasures against financial institutions.

Most Korean financial institutions and companies were not familiar with debt-for-equity swaps<sup>19</sup> until late 1997, when Korea encouraged the parties to overcome the foreign currency crisis and pursue economic revival. Neither the Debtor Rehabilitation and Bankruptcy Act (DRBA)<sup>20</sup> nor the KCA<sup>21</sup> specifically refer to the debt-for-equity swap, which is a financial instrument used to improve financial structure. To restructure, usually a company increases capital by issuing new shares, engaging in overseas sales and transfers of assets, soliciting foreign investment, or selling or otherwise transferring its holdings. However, after Korea's foreign currency crisis, these measures were unviable because the stock market had fallen and the real estate market was depressed.<sup>22</sup> Additionally, selling assets was difficult because the interest rate was high.<sup>23</sup> It was hard to find purchasers in Korea or abroad, especially considering Korea's economic reputation had also sharply declined.<sup>24</sup> Because Korean companies suffered from problems with their accounting data (including false entries and lack of clarity, corporate governance difficulties, and complicated mutual guarantees between subsidiary companies), many domestic and foreign investors were unwilling to buy their assets.<sup>25</sup> In particular, financial institutions' equity capital and lending capacity gradually and precipitously dropped as insolvent compa-

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<sup>19</sup> See Derek Asiedu-Akrofi, *A Comparative Analysis of Debt for Equity Swap Program in Five Major Debtor Countries*, 12 HASTINGS INT'L & COMP. L. REV. 537, 540 (1989). The debt-for-equity swap mechanism between Latin America countries and Korea differs slightly as to several points. *Id.* First of all, the Latin America countries exchanged sovereign debts to local currency equity in a local company; the Korean debt-for-equity swap was not sovereign debt, rather it swapped individual private company's debt to domestic financial institutions. *Id.* Thus, the issues related to the swap are different. *Id.*

<sup>20</sup> See generally Chaemuja hoebog mit pasanbeob [Debtor Rehabilitation and Bankruptcy Act], Act. No. 7428, Mar. 31, 2005, *amended by* Act. No. 12892, Dec. 30, 2014, (S. Kor.), [http://elaw.klri.re.kr/eng\\_service/lawView.do?hseq=33349&lang=ENG](http://elaw.klri.re.kr/eng_service/lawView.do?hseq=33349&lang=ENG).

<sup>21</sup> See generally Sangbeob [Commercial Act], Act No. 1000, Jan. 20, 1962, *amended by* Act No. 10696, May 23, 2011, (S. Kor.), translated in Korea Legislation Research Institute online database, [http://elaw.klri.re.kr/eng\\_service/main.do](http://elaw.klri.re.kr/eng_service/main.do) (login and search required).

<sup>22</sup> Kim Kihwan, The 1997-98 Korean Financial Crisis: Causes, Policy Response, and Lessons, Presentation at The High-Level Seminar on Crisis Prevention in Emerging Markets Organized by The International Monetary Fund and The Government of Singapore, July 10-11, 2006, <https://www.imf.org/external/np/seminars/eng/2006/cpem/pdf/kihwan.pdf>.

<sup>23</sup> *Id.* at 12.

<sup>24</sup> *Id.* at 13-14.

<sup>25</sup> *Id.* at 14.

nies suffered from nonperforming loans and increased claims.<sup>26</sup> Thus, financial institutions were at a high risk of insolvency, and some actually entered bankruptcy.

The debt-for-equity swap, which converts loan obligations of insolvent companies into investments, emerged as a way to break this vicious cycle. Under these circumstances, the debt-for-equity swap emerged as the most attractive measure; it transfers debt items to capital items without actual transfer of capital.<sup>27</sup>

From a legal perspective, in a debt-for-equity swap creditors such as financial institutions become subscribers of a paid-in capital increase through a third party allotment of newly issued shares.<sup>28</sup> The legal status of the financial organization changes from creditor to shareholder, bringing with it a change in responsibilities. Essentially, financial institutions convert loans into investments to promote corporate restructuring and obtain the right to actively intervene in corporate management.<sup>29</sup> By doing so, companies can save on financial costs (such as interest), reduce their debt ratio, and improve their financial structure through additional capital financing.<sup>30</sup> However, a debt-for-equity swap needs a legal framework to minimize any adverse effects and maximize its usefulness.

#### A. Background

The debt-for-equity swap is a type of loan restructuring. It was used to solve foreign debt issues in South American countries including Chile,<sup>31</sup> Brazil,<sup>32</sup> and Argentina<sup>33</sup> in the early 1980s.<sup>34</sup> The debt-for-equity swap is generally

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<sup>26</sup> *Id.*

<sup>27</sup> See Larry D. Soderquist, A. A. Sommer, Jr., Pat K. Chew, Linda O. Smiddy, *Corporations and other Business Organizations: Cases, Materials, Problems* 172 (Michie 4th ed., 1997). Appendix Tables 2 and 3 are hypothetical balance sheets that may aid in understanding the debt-for-equity swap.

<sup>28</sup> In Korea the acceptance of new shares in a paid-in capital increase is roughly separated into: (i) allotment to shareholders, (ii) priority subscription of shareholders, (iii) allotment to third parties, and (iv) general public subscription. See Negotiable Securities Issuance and Notification Act art. 57.

<sup>29</sup> *Debt/Equity Swap*, INVESTOPEDIA, <http://www.investopedia.com/terms/d/debtequityswap.asp> (last visited May 29, 2017).

<sup>30</sup> *Id.*

<sup>31</sup> See *Chilean Debt*, UNIV. IOWA CTR. INT'L FIN. & DEV., [https://web.archive.org/web/20110204132828/http://www.uiowa.edu/ifdebook/ebook2/glossary/Chilean\\_debt.shtml](https://web.archive.org/web/20110204132828/http://www.uiowa.edu/ifdebook/ebook2/glossary/Chilean_debt.shtml) (last visited Apr. 2, 2017). Chile's debt-to-equity program generated \$9.7 billion in swaps between 1985 and 1990. *Id.* During the first three-and-a-half years of the program, the swaps accounted for twenty-nine percent of Chile's medium and long-term debt to commercial banks. *Id.*; see also Asiedu-Akrofi, *supra* note 19, at 541–45.

<sup>32</sup> See Antonio Tavares Paes, Jr., *Brazil's Debt to Equity Swap Program*, 23 INT'L L. 533, 535 (1989) (introducing Brazil's history of debt to equity conversion, structure of regulations, and re-

used indirectly, where international mediation agencies, such as investment banks, connect financial institutions and investors and convert foreign loans into stocks.<sup>35</sup>

In detail, a bank in the borrowing country sells loan obligations (foreign currency obligations) to investors at discounted prices.<sup>36</sup> The investors present loan obligations to the borrowing country's central bank and exchange the par value of loans into local currency.<sup>37</sup> In this case, the exchange rate is better than what is offered in the market. The investors use the local currency to pay for the borrowing company's capital increase, and the company uses the payment to repay the central bank's foreign currency loan obligations; thus completing the debt-for-equity swap process.<sup>38</sup>

To explain the framework of a debt-for-equity swap,<sup>39</sup> four parties are necessary, i.e., Indebted Nation Central Bank, Indebted Nation Company X, Creditor Nation Loaned Bank, and Investor. In this hypothetical, assume that there is a \$1 billion foreign currency loan among the parties. Also assume that the exchange rate is one U.S. dollar for 1,500 KRW, with the KRW/Dollar exchange rate applying a 20% discount rate.

To begin, Indebted Nation Company X sells the loan (valued at \$1 billion, discount rate at 20%) for 80% of its value (\$800 million in cash) to the investor. Secondly, the investor sells \$1 billion in bonds to Indebted Nation Central Bank. Indebted Nation Central Bank pays 1,500 billion KRW to the investor. Thirdly, stock (par value of 1,500 billion KRW) is issued to Creditor Nation Loaned Bank. Indebted Nation Central Bank pays a subscription price of 1,500 billion KRW. Fourthly, Investors pay 1,500 billion KRW and exhibit \$1 billion worth of bonds. Lastly, Creditor Nation Loaned Bank extinguishes credit and debts into the Indebted Nation Company X.

International debt-for-equity swaps allow lending banks to achieve liquidi-

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sults); *see also* Asiedu-Akrofi, *supra* note 19, at 546–49.

<sup>33</sup> *See* Asiedu-Akrofi, *supra* note 19, at 549–54.

<sup>34</sup> *See id.* at 540 (discussing the swap process and mechanism).

<sup>35</sup> Stephen M. Wallenstein & James R. Silkenat, *Investment funds and Debt-Equity Swap: Broadening the Base of a New Financial Tool*, 12 FORDHAM INT'L L.J. 8, 8–10 n.3 (1988).

<sup>36</sup> *See* Paes, *supra* note 32, at 534; *see also* Christopher Gottscho, *Debt-Equity Swap Financing of Third World Investments—Will the I.R.S. Hinder U.S. Swappers?* 8 VA. TAX REV. 143 (1988–1989).

<sup>37</sup> *See* Asiedu-Akrofi, *supra* note 19, at 543.

<sup>38</sup> *See id.* at 543.

<sup>39</sup> Dana R. Visser & Guillermo A. Mendoza, *Debt-for-Nature Swaps in Latin America*, 92(6) J. FORESTRY 13–16 (1994); *see also* William Reilly, *Using International Finance to Further Conservation: The First 15 Years of Debt-for-Nature Swaps*, in SOVEREIGN DEBT AT THE CROSSROADS: CHALLENGES AND PROPOSALS FOR RESOLVING THE THIRD WORLD DEBT CRISIS 197–214 (Chris Jochnick & Fraser A. Preston eds., 2006).

ty and improve the soundness of their financial structures by selling loan credits.<sup>40</sup> They also allow borrowing countries to convert international debts into domestic stock to mitigate foreign claims and increase direct investment for enhanced technology transfers and job creation.<sup>41</sup> Even more, entities have the opportunity to make overseas investments and save money by purchasing loan credits at discounted prices.<sup>42</sup>

As borrowing countries issue local currency to purchase loan credits from foreign investors, the pressure of inflation<sup>43</sup> and the discounted sale of loan obligations may increase new loan interest rates in international markets.<sup>44</sup> Thus, borrowing countries might mitigate the debt-for-equity swap amount restrictions to support international debt-for-equity swaps or apply an official exchange rate to relieve the risk of exchange rate fluctuation at the time of collection. As a way to eliminate drawbacks, long-term investment is encouraged<sup>45</sup> or remittance of principal or gains is withheld for a certain period of time.<sup>46</sup> The success of this system depends on how incentives and investment regulations are managed.

International debt-for-equity swaps were most successful in Chile between 1985 and 1988.<sup>47</sup> Among its \$21 billion in foreign debts, \$2.1 billion (10%) were reduced through the debt-for-equity swap program.<sup>48</sup> On the other hand, Korea had yet to use international debt-for-equity swaps at the time of the crash because of national image problems, complexities in the international negotiations process, foreign currency issues, and legalization loopholes.<sup>49</sup>

The debt-for-equity swap is also used to restructure insolvent companies. After several foreign currency crises, Mexico's borrowing banks applied the debt-for-equity swap to reorganize Alfa Group Inc., while in Korea, Hankook Heavy Industries Inc. and Daewoo Heavy Industries Inc. used it to consolidate

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<sup>40</sup> See Asiedu-Akrofi, *supra* note 19, at 571.

<sup>41</sup> Daniel Boaman, *Debt-Equity Conversions and Other Swaps: Experience and Prospects for the Caribbean* [sic], XXII Annual Conference of the Regional Programme of Monetary Studies, Georgetown, Guyana 1–22 (Oct. 15–19, 1990).

<sup>42</sup> *Id.*

<sup>43</sup> See Walter Douglas Stuber, *The Brazilian Debt-Equity Swap Program*, 7 INT'L FIN. L. REV. 33 (1988); see also *Debt-Equity Swaps Have a Place in Mexican Relief*, N.Y. TIMES (July 3, 1989), <http://www.nytimes.com/1989/07/03/opinion/1-debt-equity-swaps-have-a-place-in-mexican-relief-613689.html>; see also Asiedu-Akrofi, *supra* note 19, at 569.

<sup>44</sup> See Stuber, *supra* note 43, at 616.

<sup>45</sup> See Gottscho, *supra* note 36, at 143.

<sup>46</sup> Brazilian regulations have imposed the restriction that the remittance may not exceed 8% of the registered foreign capital in each fiscal year. See Paes, *supra* note 32, at 536, 538.

<sup>47</sup> See generally Asiedu-Akrofi, *supra* note 19, at 571.

<sup>48</sup> See Asiedu-Akrofi, *supra* note 19, at 545.

<sup>49</sup> KYU-SUNG LEE, W. BANK & KOREA DEV. INST., *THE KOREAN FINANCIAL CRISIS OF 1997 ONSET, TURNAROUND, AND THEREAFTER* 395 (2011).

loan obligations in 1980 and 1987, respectively.<sup>50</sup> However, these swaps were in the form of financial subsidies, pursuant to the government's industrial rationalization policy, and were simple debt-for-equity swaps made by one financial institution.<sup>51</sup>

In late 1997, during the inflow of IMF rescue funds into Korea, Hanshingongyeong Inc.<sup>52</sup> and Halla Pulp and Paper, Inc.,<sup>53</sup> among many other large companies that became insolvent, entered corporate reorganization and composition proceedings.<sup>54</sup> Hanshingongyeong Inc. used direct debt-for-equity swaps with financial institutions while Halla Pulp and Paper used indirect debt-for-

<sup>50</sup> LEE, *supra* note 49, at 297–299, 340.

<sup>51</sup> Tetsuji Okazaki, *The Government-Firm Relationship in Postwar Japanese Economic Recovery: Resolving the Coordination Failure by Coordination in Industrial Rationalization*, in *THE ROLE OF GOVERNMENT IN EAST ASIAN ECONOMIC DEVELOPMENT: COMPARATIVE INDUSTRIAL ANALYSIS* 81 (Oxford Univ. Press ed., 2005).

<sup>52</sup> Hanshingongyeong Inc. filed bankruptcy in June 1997 and commenced a court receivership in December. See Seungbum Kim, *Legal Aspects of the Debt Equity Swap* (June 2002) (unpublished Ph.D dissertation, SungKyunKwan Univ. Graduate School) (on file with the SungKyunKwan Univ. Graduate School). The lending banks led by Seoul Bank, the leading bank, agreed to the reorganization plan including a debt-for-equity swap in June 1998 which obtained court approval. *Id.* Thus, 15% of the collateral KRW 529 billion in claims (KRW 79.4 billion) was subject to a debt-for-equity swap. *Id.* Seoul Bank contributed KRW 64.5 billion to the debt-for-equity swap and became the leading shareholder. *Id.*

<sup>53</sup> *Id.* Halla Pulp and Paper filed bankruptcy in December 1997 and sold loan obligations from a domestic financial organization to Bowater of the United States in composition status. See *id.* at 18. It was recorded as the first attempt in Korean history to undertake an international Merger and Acquisition (M&A) by selling loan obligations. *Id.* Claims held by twenty-one financial creditors and 300 commercial creditors were sold at discounted prices. *Id.* As a result, the company was sold for \$220 million, including full repayment of approximately KRW 400 billion in debts. *Id.*

<sup>54</sup> Under the Composition Act of Korea (KCoA), in cases where grounds for bankruptcy exist or have the potential to occur, a debtor may file an application for commencement of composition. Composition Act, Act. No. 997, Jan. 10, 1962, *amended* by Act No. 6627, Jan. 26, 2002, art. 12(1), [https://elaw.klri.re.kr/kor\\_service/lawView.do?lang=ENG&hseq=1219](https://elaw.klri.re.kr/kor_service/lawView.do?lang=ENG&hseq=1219). In applying for commencement of composition, the method of repayment, or in furnishing security, the security and other conditions of composition, shall be reported to the court. *Id.* art. 13(1). The applicant for composition shall produce a detailed statement regarding its assets and a list of creditors and debtors simultaneously with the application. *Id.* art. 13(2). When these are not produced simultaneously with the application, they shall be produced immediately thereafter. *Id.* After the composition has commenced, an application for bankruptcy may not be filed, and conversely, after a bankruptcy has been adjudicated, an application for a commencement of composition may not be filed. *Id.* arts. 15–16. A commencement of composition shall not affect the rights of a debtor regarding administration and disposition of his own assets. *Id.* art. 32(1). During the composition procedure, compulsory execution, provisional attachment, or provisional disposition of the debtor's property shall not be made by composition creditors. *Id.* art. 40(1). The compulsory execution, provisional attachment, and provisional disposition on the debtor's property in relation to composition creditors made prior to the commencement of composition shall be suspended during the composition procedure. *Id.* art. 40(2). If the composition has been approved at the meeting of creditors, the court shall determine the approval or disapproval of the composition on that date or an immediately announced date. *Id.* art. 54(1). After the court has finally approved the composition, it shall be entered into. *Id.* art. 58.



equity swaps by selling a bank's loan credits to third parties.<sup>55</sup>

Despite the previous examples, the debt-for-equity swap is not always used to reduce foreign credits or corporate debts. The debt-for-equity swap was widely used in the United States in the early 1980s, not to decrease debt ratios, but to avoid taxes.<sup>56</sup> Before the 1980s, U.S. companies did not pay taxes on gains when they purchased their own claims with sinking funds used for repayment.<sup>57</sup> However, the new tax law in 1981 imposed taxes on company claims purchased with sinking funds;<sup>58</sup> hence, companies began using the debt-for-equity swap to reduce claims and avoid taxation.

### *B. Methods*

Subjects of a debt-for-equity swap can be classified into several groups. This study classifies companies under DRBA into insolvent companies, workout companies (those working on corporate financial improvement),<sup>59</sup> and financially-solid companies (all others). However, companies with solid financial structures infrequently use debt-for-equity swaps.

Financial institutions may choose between two methods for executing a debt-for-equity swap of loan claims: in the first method, claims are converted into in-kind investment through the debt-for-equity swap, while in the second, the consideration for subscription payments for shares of stock is provided through a set-off against the claims.

In in-kind investment,<sup>60</sup> creditors invest claims directly in their debtor.<sup>61</sup> There is a dispute concerning whether such in-kind investments are legal under the KCA. Further, the debt-for-equity swap using an in-kind investment requires a complicated inspection process. At the time of incorporation, the procedure should be indicated as an abnormal incorporation in the bylaws<sup>62</sup> and un-

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<sup>55</sup> See generally Seungbum Kim, *supra* note 52.

<sup>56</sup> See Monica Prasad, *The Popular Origins of Neoliberalism in the Reagan Tax Cut of 1981*, 24 J. POL'Y HIST. 351, 353–59 (2012).

<sup>57</sup> *Id.*

<sup>58</sup> *Id.* The Economic Recovery Tax Act of 1981, also known as the ERTA or “Kemp-Roth Tax Cut,” was a federal law enacted in the United States in 1981. *Id.*

<sup>59</sup> In Korea, a corporate financial improvement workout is a series of processes through which a company that is slightly insolvent and has the potential to revive itself through a financial restructuring pursues such an improvement by negotiating with financial institutions.

<sup>60</sup> In Japan, the rationale of the debt-for-equity swap is that the creditors invest their claims with in-kind investment to the company. See Kanda Hiteki, *Debt-Equity-Swap*, JURIST NO. 1219, 32 (Mar. 15, 2002).

<sup>61</sup> See *Payment-In-Kind*, INVESTOPEDIA, <http://www.investopedia.com/terms/p/paymentinkind.asp> (last visited May 26, 2017).

<sup>62</sup> Sangbeob [Commercial Act], Act No. 1000, Jan. 20, 1962, *amended by* Act No. 10696, May

dergo an inspection by a court-appointed inspector or certified appraiser.<sup>63</sup>

The second method is the subscription price payment by set-off. This is the simplest debt-for-equity swap method and requires one to set-off creditors' payment obligations against the subscription price of shares.<sup>64</sup> The key is how the KCA would combine the provision that prohibits set-offs of claims that subscribers have against companies<sup>65</sup> with the subscription price payment by set-off. Article 334 of the KCA, which prohibits subscription price payment by set-off, burst onto the scene when the debt-for-equity swap emerged as an important financial device in relation to corporate restructuring during the Asian financial crisis.<sup>66</sup> Thus, companies have encountered practical hardships in applying this method.

### *C. Effects*

#### *1. Economic Effects*

The following paragraphs will discuss the positive effects of debt-for-equity swaps. When financial institutions convert loan claims through debt-for-equity swaps, company capital increases and debts decrease.<sup>67</sup> This makes for highly effective and improved financial restructuring.<sup>68</sup> Companies are freed from the burden of high interest rates<sup>69</sup> and are more likely to increase their operating income. Companies that obtain solid financial structures through the debt-for-equity swap can then engage in active investments and use mergers, splits, or asset sales to further the restructuring process.<sup>70</sup>

Financial institutions can preserve claims by providing passive tactics, such as interest deductions or interest rate adjustments, but the debt-for-equity swap of loan claims can bring higher gains if stock values increase in the fu-

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23, 2011, art. 290(2) (S. Kor.), translated in Korea Legislation Research Institute online database, [http://elaw.klri.re.kr/eng\\_service/main.do](http://elaw.klri.re.kr/eng_service/main.do) (login and search required).

<sup>63</sup> *Id.* art. 299(1)–(2).

<sup>64</sup> THOMSON REUTERS, PRACTICAL LAW: SET-OFF, [https://uk.practicallaw.thomsonreuters.com/4-107-7242?\\_\\_lrTS=20170526231939052&transitionType=Default&contextData=\(sc.Default\)&firstPage=true&bhcp=1](https://uk.practicallaw.thomsonreuters.com/4-107-7242?__lrTS=20170526231939052&transitionType=Default&contextData=(sc.Default)&firstPage=true&bhcp=1) (last visited May 26, 2017).

<sup>65</sup> *Id.* art. 334.

<sup>66</sup> Michael P. Dooley, *Origins of the Crisis in Asia*, in *THE ASIAN FINANCIAL CRISIS: ORIGINS, IMPLICATIONS, AND SOLUTIONS* 27–31 (William C. Hunter et al. eds., 1999).

<sup>67</sup> Gottscho, *supra* note 36, at 152.

<sup>68</sup> *Id.*

<sup>69</sup> *Id.*

<sup>70</sup> INTERNATIONAL MERGERS & ACQUISITION, DEBT AND EQUITY RESTRUCTURING, <http://www.intermerger.eu/transaction-support-service/debt-and-equity-restructuring/> (last visited May 26, 2017).

ture.<sup>71</sup> The debt-for-equity swap of loan claims makes the creditors (i.e., financial institutions) into shareholders and enables them to practice certain rights.<sup>72</sup> After a debt-for-equity swap of a sufficient magnitude, the financial institutions can actually intervene in the management to replace incapable board members or auditors and operate a supervisory system.<sup>73</sup>

The next paragraphs will discuss the negative effects of debt-for-equity swaps. The debt-for-equity swap is sometimes used to increase a bank's Bank for International Settlements (BIS) ratio by decreasing a financial institution's potential insolvency claims; rather than promoting the debtor company's revival.<sup>74</sup> In this case, the financial institution may increase the insolvency risk by putting in more money to keep its BIS rate from falling, even though the company receiving the loan lacks the potential to be revived in terms of long-term cash flow.<sup>75</sup> In addition, such a company may depend on the bank's financing even after the debt-for-equity swap and may make less effort to improve management and avoid risks, increasing expenditures.<sup>76</sup> If a financial institution chooses the wrong company, it may lose both its original loan claims and additional support funds.

Furthermore, not all interested parties involved in a company may perceive a debt-for-equity swap as good. Leading or majority shareholders or management may strongly oppose a debt-for-equity swap program, fearing its dilution of existing shareholder holdings or its threat to management's employment. In fact, Gyeonggi Chemicals Inc. terminated its workout process because controlling shareholders rejected a capital decrease via the proposed debt-for-equity swap.<sup>77</sup>

In extreme cases, the central bank has to take charge of a financial institution's lack of liquidity caused by private firm management failure.<sup>78</sup> This may

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<sup>71</sup> Matt Lee, *What is a Debt/Equity Swap?*, INVESTOPEDIA, <http://www.investopedia.com/ask/answers/06/debtequityswap.asp> (last visited May 26, 2017).

<sup>72</sup> *Id.*

<sup>73</sup> See Asiedu-Akrofi, *supra* note 19, at 568–71, for a detailed discussion of how the debt-for-equity swap's economic effects differ from scheme to scheme.

<sup>74</sup> See Gottscho, *supra* note 36, at 152 (a debt-for-equity swap also provides banks with the benefits of risk diversification).

<sup>75</sup> See Gottscho, *supra* note 36, at 152 n.30 (commentators have argued that at an extremely macroeconomic level, a debt-for-equity swap transaction might be thought of as an implicit bankruptcy).

<sup>76</sup> See Gottscho, *supra* note 36, at 154 n.40.

<sup>77</sup> Yeongryeol Lee, *Gyeonggi Chemicals Inc. Terminated its Workout Process*, JOONGANG DAILY (Mar. 16, 1999), [http://gangnam.joins.com/news/article/Article.aspx?total\\_id=3760516&sc=&mc=](http://gangnam.joins.com/news/article/Article.aspx?total_id=3760516&sc=&mc=).

<sup>78</sup> Henry C. K. Liu, *The Wizard of Bubbleland: Part II: The Repo Time Bomb*, ASIA TIMES (Sept. 29, 2005), [http://www.atimes.com/atimes/Global\\_Economy/GI29Dj01.html](http://www.atimes.com/atimes/Global_Economy/GI29Dj01.html) (explaining mod-

cause the central bank to expand its role as the final lender to the industry in the national economy. Once financial institutions process debt-for-equity swaps of loan claims, the insolvency caused by management may spread to the financial institutions themselves. If public funds are injected, the impact of the insolvency may be felt by the general public through taxes being used to maintain insolvent companies.

## 2. Legal Effects

The debt-for-equity swap gives effect to shareholders in both rights and duties. Shareholder rights are not subject to conveyance, pledge, or seizure, separate from the sale of the stock itself, and are under no statute of limitations.<sup>79</sup> However, shareholders may have various rights besides their status as shareholders, which are called creditor or third party rights.<sup>80</sup> These must be clearly distinguished from shareholders' rights. Shareholders' right to claim dividends is an example.<sup>81</sup> This right comes from the right to claim profits but is subject to transfer or pledge, separate from stock certificates, when it is actualized through a shareholders' meeting.<sup>82</sup> It can also be subject to a statute of limitations and is obviously not transferred to beneficiaries, even when shares are transferred.<sup>83</sup>

In the debt-for-equity swap, the creditors' legal status changes to that of shareholders, providing new rights and duties.<sup>84</sup> The shareholder's sole duty is "limited to the subscription price which he has paid for his shares."<sup>85</sup> Regardless of whether it is a pecuniary contribution or in-kind investment, this duty of limited contribution must be fulfilled before incorporation of a company or before new shares become effective.<sup>86</sup> Thus, this is a duty one has before becoming a shareholder.<sup>87</sup> Shareholders do not have any additional duty once they become

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ern central banking functions in detail).

<sup>79</sup> Julian Velasco, *The Fundamental Rights of the Shareholder*, 40 U.C. DAVIS L. REV. 407 (2006).

<sup>80</sup> *Id.* at 439.

<sup>81</sup> *Id.* at 413.

<sup>82</sup> *Id.* at 420–21.

<sup>83</sup> *See generally id.*

<sup>84</sup> Sangbeob [Commercial Act], Act No. 1000, Jan. 20, 1962, *amended* by Act No. 10696, May 23, 2011, art. 331 (S. Kor.), translated in Korea Legislation Research Institute online database, [http://elaw.klri.re.kr/eng\\_service/main.do](http://elaw.klri.re.kr/eng_service/main.do) (login and search required).

<sup>85</sup> *Id.*

<sup>86</sup> *Id.* arts. 295, 421.

<sup>87</sup> *Id.* arts. 295, 305, 421.

shareholders.<sup>88</sup>

A payment of the subscription price in exchange for stock must be made in cash to meet capital adequacy needs, with payment by accord and satisfaction not being accepted.<sup>89</sup> Payment is complete when the notes or checks are provided.<sup>90</sup> Again, Article 334 of the KCA provides that a shareholder may not assert a set-off against the company in regards to payment of the subscription price for shares.<sup>91</sup> This provision applies to capital adequacy.<sup>92</sup>

### III. PREVIOUS OPERATING EXPERIENCE AND EXEMPLARY CASES

Whether the scope is broad or narrow; whether the cases are many or few; and whether there is a statute or not, many countries use debt-for-equity swaps to restructure companies facing corporate financial distress. In this Part, debt-for-equity swap cases from several countries will be introduced together with their corporate restructuring history. Each country has a different legal background and business culture, but shares common characteristics with the others. This Part will also provide an overview of different legislative perspectives to solving the problems arising from the relationship between a bankrupt corporation and its creditors.

#### A. Mexico

##### 1. Foreign Currency Crises and Corporate Restructuring

Mexico, which has undergone multiple foreign currency crises,<sup>93</sup> has barely achieved solidity, and given the pessimistic atmosphere that continues from the recession, one cannot conclude that its economy is experiencing revival. In Mexico, governmental subsidies promoted corporate restructuring.<sup>94</sup> Briefly stated, Mexico easily overcame its first crisis in 1976 by absorbing U.S. dollars

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<sup>88</sup> *See id.*

<sup>89</sup> *Id.* art. 305.

<sup>90</sup> Supreme Court [S. Ct.], 76Da943, Apr. 12, 1977 (S. Kor.).

<sup>91</sup> Sangbeob [Commercial Act], Act No. 1000, Jan. 20, 1962, *amended by* Act No. 10696, May 23, 2011, art. 334 (S. Kor.), translated in Korea Legislation Research Institute online database, [http://elaw.klri.re.kr/eng\\_service/main.do](http://elaw.klri.re.kr/eng_service/main.do) (login and search required).

<sup>92</sup> *Id.*

<sup>93</sup> *See* Joseph A. Whitt, Jr., *The Mexican Peso Crisis*, 81 FED. RES. BANK OF ATLANTA ECON. REV. 1 (1996), [https://www.frbatlanta.org/-/media/documents/research/publications/economic-review/1996/vol81no1\\_whitt.pdf](https://www.frbatlanta.org/-/media/documents/research/publications/economic-review/1996/vol81no1_whitt.pdf).

<sup>94</sup> *Id.*

through the discovery of oil fields.<sup>95</sup> At that time, the Mexican government acquired insolvent companies and converted them into public corporations.<sup>96</sup> The crisis of 1982, however, was not as simple and continued for several years.<sup>97</sup> Corporate restructuring began around 1987, when the government initiated re-scheduling and labor-management negotiations.<sup>98</sup> The 1994 crisis was not as severe because many companies already had undergone drastic restructurings after the second crisis.<sup>99</sup>

Throughout the foreign currency crisis, Mexican companies focused on (i) debt payment rescheduling,<sup>100</sup> (ii) corporate governance improvement, and (iii) employment and labor adjustment. These companies used government policies, appealed to the government and interested parties, and employed a holding company system to improve their business structure.<sup>101</sup> In the end, CEO determinations empowered the restructuring.<sup>102</sup> The government used the agreements between labor, management, and government at large (the so-called “Pacto”)<sup>103</sup> to limit wage increases while also permitting debt readjustment and governance restructuring for companies facing insolvency in the pursuit of management normalization.<sup>104</sup>

## 2. Key Issues Regarding Mexico’s Corporate Restructuring

(1) *Rescheduling*: The Mexican government executed various programs for the rescheduling of financially troubled companies’ payments.<sup>105</sup> These were

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<sup>95</sup> *The Mexican 1982 Debt Crisis*, RABORESEARCH—ECON. REPORT (Sept. 19, 2013), <https://economics.rabobank.com/publications/2013/september/the-mexican-1982-debt-crisis/>.

<sup>96</sup> *Id.*

<sup>97</sup> Whitt, *supra* note 93, at 5, 8.

<sup>98</sup> One researcher argues that “Mexico’s main liberalizing reforms were launched in 1988 during the last year of the De la Madrid administration and they were pursued ‘aggressively’ by the new government of Carlos Salinas de Gortari, who took office at the end of the year.” See Geneviève Marchini, *Financial Liberalization, the Banking Crisis and the Debtors’ Movement in Mexico*, 1 PORTAL 2, 2 (July 2004), <http://epress.lib.uts.edu.au/journals/index.php/portal/article/view/61/38> (click “fullscreen” or “download PDF”). Structural reforms were coupled with a new stabilization program that had been introduced earlier in December 1987, in order to attack a threatening inflationary economy. *Id.*

<sup>99</sup> Whitt, *supra* note 93, at 2–7.

<sup>100</sup> *Mexico’s Debt Hat-Trick*, THE ECONOMIST (Vol. 339 Issue 7971) at 75. (June 22, 1996); *Brady’s Mexican hat-trick* (Nicholas F. Brady on debt-relief to Mexico), THE ECONOMIST (July 29, 1989).

<sup>101</sup> *Id.*

<sup>102</sup> *Id.*

<sup>103</sup> See Marchini, *supra* note 98, at 4–5.

<sup>104</sup> *Id.*

<sup>105</sup> Laurence Hecht and Peter Morici, *Managing Risks in Mexico*, HARVARD BUS. REV. (1993),

characterized by government shepherding and not the guidance of companies or financial institutions.<sup>106</sup> Because a high percentage of companies in Mexico were public, government intervention was essential. With the sharp drop in the exchange rate and correspondingly high interest rates, companies needed government intervention to normalize their management and open markets to alleviate uncertainties.<sup>107</sup>

The Mexican government used the following five methods for its payment restructuring program. In 1982, the Mexican peso dropped sharply and local companies needed to consolidate international debts.<sup>108</sup> Thus, the Foreign Exchange Risk Coverage Trust Fund (FICORCA) was introduced to support repayment of international debts using guarantees to avoid the exchange rate risk.<sup>109</sup> Other rescheduling measures introduced in 1994 include: (1) Unidad de Inversión (UDI),<sup>110</sup> a rescheduling program to prevent the spread of company insolvency; (2) *Fondo Bancario de Protección al Ahorro*, or Banking Fund for the Protection of Savings (FOBAPROA);<sup>111</sup> (3) ADE, a debt and interest deduction program for small or medium-sized companies and private households; and (4) FOPYME, a small or medium-sized company rescue program.<sup>112</sup> Using these methods, companies processed debt-for-equity swaps,<sup>113</sup> debt rescheduling, conversion of international debts into local currency, asset sales, joint venture investment, and debt reduction.

(2) *Changes in Possessions and Corporate Governance*: From the 1960s until the 1982 foreign currency crisis, Mexico's largest private companies were held (up to 80%) by only a few families.<sup>114</sup> These families maintained an exclu-

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<https://hbr.org/1993/07/managing-risks-in-mexico> (last visited June 10, 2016).

<sup>106</sup> *Id.*

<sup>107</sup> *Id.*

<sup>108</sup> *Id.*

<sup>109</sup> See Mark R. Stone, *Corporate Sector Restructuring: The Role of Government in Times of Crisis*, INT'L MONETARY FUND (No. 31) (June 2002), <http://www.imf.org/external/pubs/ft/issues/issues31/index.htm>.

<sup>110</sup> The program included rescheduling and sought to avoid anticipated amortization of capital due to high inflation. See Marchini, *supra* note 98, at 23.

<sup>111</sup> "FOBAPROA was originally established in 1990 as a fund of the sector of privatized Mexican banking, so that in trouble banks would turn to this fund rather than using public resources." Barbara Hogenboom, *Economic Concentration and Conglomerates in Mexico*, 20 J. DEVELOPING SOCIETIES 217 (2004), <http://journals.sagepub.com/doi/abs/10.1177/0169796X04050959?legid=spjds%3B20%2F3-4%2F207&patientinform-links=yes>.

<sup>112</sup> See Marchini, *supra* note 98 **Error! Bookmark not defined.**, at 23.

<sup>113</sup> AAM, *Creditors get 40% AHMSA [Altos Hornos de Mexico San Antonio] Stake in SWAP for Cutting \$1.7B Debt*, AM. METAL MKT., Vol. 109 Issue 106, at 3 (June 1, 2001).

<sup>114</sup> See Kim, *supra* note 52, at 22; see also RODERIC A. CAMP, *ENTREPRENEURS AND POLITICS IN TWENTIETH-CENTURY MEXICO* 86 (1989).

sive structure of possession without any public exposure until the crisis.<sup>115</sup>

This exclusivity was reduced to 50% after the foreign currency crisis because foreign investments from the United States and Europe doubled.<sup>116</sup> Large companies' formal management powers were removed through the rescheduling process, but their actual possession and management maintained because the government and financial organizations focused on management normalization rather than intervening in or removing management.<sup>117</sup>

(3) *Adjustment of Employment and Wages*: The Pacto between labor, management, government, and agricultural associations found a societal middleground for employment and wage conflicts.<sup>118</sup> The Pacto became official in 1987 and was used as an important policy measure during the 1994 foreign currency crisis.<sup>119</sup> The Zedillo government declared the Economic Crisis Conquest Convention (AUSEE)<sup>120</sup> on January 3, 1995.

Mexico encountered massive unemployment in the process of overcoming its financial crises. The unemployment rate was 8% in 1982, but reached 20% six years later.<sup>121</sup> In early 1986, major factories were closing at a rate of one every three days, leaving 1,500 more people unemployed, daily.<sup>122</sup> However, laborers did not assert their rights and their representatives did not raise disputes regarding dismissals.<sup>123</sup> Thus, employment adjustment did not encounter many

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<sup>115</sup> See Camp, *supra* note 114.

<sup>116</sup> See Kim, *supra* note 52, at 22; see also ROBERT K. SCHAEFFER, UNDERSTANDING GLOBALIZATION 96 (Rowman & Littlefield Pub., 1st ed. 1997); ROBERT A. PASTOR, LATIN AMERICAN DEBT CRISIS: ADJUSTING FOR THE PAST OR PLANNING FOR THE FUTURE 9 (Lynne Rienner Pub., 1987) (stating that these investments went through international securities and joint investments).

<sup>117</sup> See Kim, *supra* note 52, at 23; see also *infra* Appendix Table 4; Miguel Leon G., *Restructuring Strategy of Mexican Conglomerates*, IPADE U. (1998).

<sup>118</sup> The Pacto was made between four parties (labor, management, government, and agricultural associations) who agreed to a master plan of economic operations. Government economists, entrepreneurs, labor workers, and agricultural organization representatives participated in the discussion, and the President of Mexico, the President of Central Bank, all related dignitaries, all labor union representatives, all management representatives, all agricultural association representatives, and local governors participated in the signing ceremony.

<sup>119</sup> *Id.*

<sup>120</sup> The essential agreement includes: (i) a restructuring plan for employment facilitation; (ii) efforts to prevent a vicious circle of inflation, exchange rate devaluation, wage increase, and inflation; and (iii) use as a primary policy method of the Mexican government seeking to pursue a financial market credit enhancement scheme to overcome the nation's currency crisis.

<sup>121</sup> See Kim, *supra* note 52, at 23–24.

<sup>122</sup> *Id.*

<sup>123</sup> See Anne Krueger & Aaron Tornell, *The Role of Bank Restructuring in Recovering from Crises: Mexico 1995-98*, 36–56 (Working Paper No. 7042, 1999), <http://www.nber.org/papers/w7042.pdf>.



conflicts.<sup>124</sup> During the currency crisis in 1994, many Mexican companies dismissed a considerable number of employees in the process of selling non-operating assets and withdrawing businesses.<sup>125</sup>

### 3. *Characteristics of Mexico's Corporate Restructuring*

Mexico's corporate restructuring has the following characteristics. First, no interested party caused conflicts or resistance because of the Pacto.<sup>126</sup> Financial institutions undertook large financial burdens because of the rescheduling, but happily cooperated for long-term profit.<sup>127</sup> Laborers and labor unions who saw the most casualties complied with wage deduction and coped with unemployment.<sup>128</sup> Second, debt payment rescheduling followed government-initiated programs.<sup>129</sup> Third, foreign investments increased in corporate holdings, but little change was seen in corporate governance.<sup>130</sup> Fourth, companies volunteered to promote employment adjustment and business restructuring.<sup>131</sup>

Mexico's corporate restructuring reflected its sociocultural characteristics, with the Pacto being possible because of Mexico's traditional corporatism,<sup>132</sup> strong power of the ruling party (PRI), concentration on power by social inequality,<sup>133</sup> and connections between large companies and banks. Government-led rescheduling did not impact corporate governance because the society did not stand against companies, and few foreign investors intervened in management.<sup>134</sup> Employment adjustments, wage deductions, and opportunities for business restructuring were available<sup>135</sup> because the labor unions cooperated and le-

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<sup>124</sup> *Id.*

<sup>125</sup> See Kim, *supra* note 52, at 23–24.

<sup>126</sup> See generally Marchini, *supra* note 98.

<sup>127</sup> See generally Marchini, *supra* note 98, at 8.

<sup>128</sup> Viviana Patroni, *Labor Deregulation and the "Official" Labor Movement in Mexico and Argentina* 6–11 (Latin Am. Stud. Ass'n 2001), <http://lasa.international.pitt.edu/Lasa2001/PatroniViviana.pdf>.

<sup>129</sup> *Id.*

<sup>130</sup> *Id.*

<sup>131</sup> *Id.*

<sup>132</sup> See *id.* Unionism has two meanings, one of which is that the government becomes an economic development driver itself by making an organization that embraces various social entities. *Id.* Another is that the government becomes an official mediator who can play a key role in peacemaking within the organization by urging social entities to express their demands. *Id.*

<sup>133</sup> See Marchini, *supra* note 98, at 4.

<sup>134</sup> See Hogenboom, *supra* note 111, at 208. Mexican entrepreneurs tend to be protective of their company operations, and even when they become transnational players, Mexican conglomerates often remain family-based and closed to outsiders. *Id.*

<sup>135</sup> See Marchini, *supra* note 98, **Error! Bookmark not defined.** at 5.

<sup>136</sup> Brady's *Mexican Hat-Trick* (Nicholas F. Brady on debt-relief to Mexico) (Finance), THE

gal corporate restrictions were weak. The United States, which was politically and economically tied to Mexico, also supported its corporate restructuring.<sup>136</sup>

#### 4. Exemplary Cases of Mexico's Corporate Restructuring

(a) *ALFA Group*: Alfa Group was Mexico's largest private company, after detaching from the Monterrey Group, which was established by the Garza Family in the 19th century.<sup>137</sup> It diversified its business in the 1970s and grew to manage 157 subsidiary companies in the early 1980s.<sup>138</sup> It faced insolvency during the second foreign currency crisis, but deferred repayment of \$2.7 billion in April 1982.<sup>139</sup> Alfa Group deferred 75% of its interest in August 1982, and recorded \$1 billion in sales and \$0.3 billion in losses that year.<sup>140</sup> It declared five years from 1982 as the period of crisis and established two holding companies for business restructuring: the "Good Company" for core businesses, and the "Bad Company" to reorganize unprofitable businesses.<sup>141</sup> In other words, New Alfa, the Good Company, was the holding company for strategic businesses, while Zeta, the Bad Company, was the holding company for liquidation and sales.<sup>142</sup>

Profitable divisions were transferred to New Alfa and a spin-off was used for sales.<sup>143</sup> New Alfa consisted of sixteen subsidiary companies, mostly in steelmaking and chemicals,<sup>144</sup> with steelmaking being its most profitable division for which it developed new processes.<sup>145</sup> The chemical division jointly developed manufacturing and processing systems with Germany's BASF and held

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<sup>136</sup> *Brady's Mexican Hat-Trick (Nicholas F. Brady on debt-relief to Mexico) (Finance)*, THE ECONOMIST (July 29, 1989), <https://www.highbeam.com/doc/1G1-7826991.html>.

<sup>137</sup> It split from the Monterrey Group, which was established by the business elites in the nineteenth century. DON M. COERVER ET AL., MEXICO: AN ENCYCLOPEDIA OF CONTEMPORARY CULTURE AND HISTORY 306 (2004).

<sup>138</sup> See Kim, *supra* note 52, at 25.

<sup>139</sup> *Id.*

<sup>140</sup> *Id.*

<sup>141</sup> *Id.* This is a successful case of corporate restructuring using the "Clean & Bad" strategy through which insolvent divisions are split-off from the existing company. *Id.*

<sup>142</sup> *Id.*

<sup>143</sup> *Id.* "Spin-off" is establishing a new subsidiary company and having existing shareholders of the parent company possess the new company's stocks. *Id.* ITT (1995) and Ford (1997) of the United States have used this method. *Id.*

<sup>144</sup> *Dupont and Alfa's Alpek Plan Polyester Fiber JV in Mexico*, CHEM. MKT. REP., May 1998, at 13, <https://www.icis.com/resources/news/1998/05/11/87330/dupont-and-alfa-s-alpek-plan-polyester-fiber-jv-in-mexico/>; see Andrew Wood, *DuPont-Alpek Extend Staple Fiber JV, Plan Mexican Plant*, CHEM. WEEK, May 1998, at 9, <https://www.highbeam.com/doc/1G1-20596920.html>.

<sup>145</sup> See Kim, *supra* note 52, at 26.

the highest productivity and most advanced technology.<sup>146</sup> New Alfa's profits were used to repay Zeta's debts.<sup>147</sup>

In the meantime, Zeta promoted sales and liquidation. The metal, travel, construction, communication, and electronic divisions were initially selected for sale and withdrawal.<sup>148</sup> Starting with the profitable ones, its divisions were sold, one by one, to third parties. New Alfa paid its debt and interest until all subsidiary companies of Zeta were sold.<sup>149</sup> Based on the complete restructuring plan, the company and the banks agreed on a debt-for-equity swap and rescheduling program.<sup>150</sup>

The company exchanged \$2 billion of debt held by the banks, including Chase Manhattan, for 45% of its stock; the banks processed the debt-for-equity swap, substituted long-term for short-term debt, and deferred repayment.<sup>151</sup> The claim holders accepted the leading shareholders' management and appointed the leading shareholders to promote intensive restructuring by selling stock through the debt-for-equity swap.<sup>152</sup>

The leading shareholders and families were given preemptive rights to shares from the debt-for-equity swap and were appointed to initiate the restructuring with adequate incentives.<sup>153</sup> With a series of corporate restructurings, Alfa Group recorded \$3.8 billion of sales and \$0.6 billion of profits in 1997, and was ranked 193rd by *Fortune* magazine among global companies.<sup>154</sup>

(b) *CEMEX Group*: The Cemex Group, established by the Lorenzo family in 1906, is currently the world's third largest cement company.<sup>155</sup> It has production and sales throughout the world, including Central and South America, the United States, Spain, and the Philippines, and earns 70% of its sales (\$3.7 billion in 1997) from international businesses.<sup>156</sup> It faced insolvency when it was expanding the business to cement, circulation, and tourism industries after the

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<sup>146</sup> *BASF Concentrating On Nylon*, CHEM. MKT. REP., Aug. 1994, at 9.

<sup>147</sup> *Id.*

<sup>148</sup> See Kim, *supra* note 52, at 26; see also *Clarendon Grp., Ltd. v. Smith Labs., Inc.*, 741 F. Supp. 1449, 1453 (S.D. Cal. 1990) ("A shareholder who has a preemptive right gets a preference to purchase newly issued shares, under certain conditions, over any other potential buyers.").

<sup>149</sup> See Kim, *supra* note 52, at 26.

<sup>150</sup> *Id.*

<sup>151</sup> See *id.* at 26.

<sup>152</sup> *Id.*

<sup>153</sup> *Id.*

<sup>154</sup> *Id.*

<sup>155</sup> *Id.*

<sup>156</sup> *Id.* at 27.

1970s, and it almost entered bankruptcy during the 1982 foreign currency crisis.<sup>157</sup>

In 1982, the Cemex Group began selling all its businesses, except for cement.<sup>158</sup> The existing cement, circulation, mining, tourism, and hotel businesses were reorganized to separate the tourism industry into an independent business and integrate all other businesses with the cement business.<sup>159</sup> Among its key businesses, assets with low productivity and high maintenance—real estate, idle facilities, and equipment—were sold.<sup>160</sup> The hotel management business was also sold to concentrate all funds in the cement business.<sup>161</sup> The company used a debt-for-equity swap and rescheduling to reduce debts.<sup>162</sup> Mexico's Banamex Bank, the leading creditor, exchanged 40% of its debts (including \$1 billion of foreign currency debts) for shares under the condition that J.P. Morgan reorganize Cemex's limited businesses through government arbitration.<sup>163</sup> At the same time, repayment of short-term debts, which constituted 55% of the company's total debt, was completely halted for a year.<sup>164</sup>

With the Mexican government's mitigation of foreign currency regulations after 1982, the company could introduce advanced financial techniques and avoid the risk of exchange rate fluctuation. The company brought in eighty financial specialists from Wall Street to run the financial team,<sup>165</sup> and actively used financial techniques such as swaps, options, and futures for hedging through the North American financial market and Euromoney.<sup>166</sup>

As part of its restructuring, the company had a vision of transforming itself into a "world-class multinational company" and actively globalizing its businesses.<sup>167</sup> To overcome the cement industry's sensitivity to economic fluctuation, the company established worldwide production and sales points for synergies and expansion, and processed mergers and acquisitions and joint investments in countries with high demand for cement, such as Brazil, the United

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<sup>157</sup> *Id.*

<sup>158</sup> *Id.*

<sup>159</sup> *Id.*

<sup>160</sup> *Id.*

<sup>161</sup> *Id.*

<sup>162</sup> *Id.*

<sup>163</sup> *Id.*

<sup>164</sup> *Id.* (evidencing a suspension from 1982 to 1983).

<sup>165</sup> Karen Sibayan, *Chase, Salomon, Deutsche Help CEMEX Buy Southdown*, BANK LOAN RPT., Oct. 2000, at 2, <https://www.highbeam.com/doc/1G1-66282677.html>.

<sup>166</sup> See Kim, *supra* note 52, at 27–28.

<sup>167</sup> *Id.* To ward off any objections, the company introduced three principles underlying its vision: (i) businesses shall not focus on one country; (ii) ultramodern technologies shall not be overlooked; and (iii) no member of the company shall be self-satisfied. *Id.*

States, and Spain.<sup>168</sup> In addition, about 60% of the company's existing manpower was dismissed and many new global employees were hired.<sup>169</sup>

(c) *VITO Group*: The VITO Group, established by the Sada family in 1914, focused on glass and plastic materials manufacturing.<sup>170</sup> As Mexico's leading glass manufacturer, in 1997 it recorded \$3 billion in sales and employed 33,000 people.<sup>171</sup> The VITO Group was not seriously affected by the foreign currency crisis in 1982 because it had maintained a low debt to investment ratio, but confronted crisis in 1993 as its sales and the value of the Mexican peso decreased sharply.<sup>172</sup>

In 1987, the company acquired Anchor Glass Company, the largest glass manufacturer in the United States, and fourteen other businesses.<sup>173</sup> Its debts, which were originally at 18 billion pesos, ballooned to 52 billion pesos because of the rapid change in the exchange rate, leaving it unable to pay.<sup>174</sup> To overcome this crisis, the company sold or reduced its businesses.<sup>175</sup> Its "[old] all businesses with less than 14% profitability."<sup>176</sup> It also negotiated with its creditors to reschedule its debts.<sup>177</sup>

In 1995, the company worked with about forty foreign banks, including J.P. Morgan, and agreed to convert \$700 million of its debt into stock.<sup>178</sup> It also worked with leading creditors, such as Mexico Development Bank and Banamex, to reschedule its debt and reduce its short-term debt ratio from 63% in 1995 to 40% in 1997.<sup>179</sup> The company actively induced foreign investments to improve its debt structure and supply equity capital.<sup>180</sup> Investment inducers were dispatched to Central and South America, the United States, Canada, and Europe for international investment relations and to introduce the company's business plans and management improvements.<sup>181</sup>

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<sup>168</sup> *Id.*

<sup>169</sup> See Kim, *supra* note 52, at 28.

<sup>170</sup> *Id.*

<sup>171</sup> *Id.*

<sup>172</sup> *Id.*

<sup>173</sup> *Id.*

<sup>174</sup> *Id.*

<sup>175</sup> *Id.*

<sup>176</sup> *Id.*

<sup>177</sup> *Id.*

<sup>178</sup> *Id.* at 29.

<sup>179</sup> *Id.*

<sup>180</sup> *Id.*

<sup>181</sup> *Id.*

By inducing foreign investments, the company repaid \$590 million of its debts within 1997 and saved \$250 million by avoiding interest payments.<sup>182</sup> With a constant decrease in employment, the company gained fluidity in managing its manpower.<sup>183</sup> Every part of the company dismissed 20%–30% of its employees, reducing the overall number from 43,000 in 1993 to 33,000 in 1996.<sup>184</sup> The company started by dismissing managers and even dismissed 7% of its workers after 1997.<sup>185</sup> In addition, many regular positions were replaced by daily or contract workers.<sup>186</sup>

In a rare move for a Mexican company, labor representatives and management gathered together once a month for discussions and negotiations.<sup>187</sup> The Sada Family used private properties to raise capital while the CEO cut his expenses by 50% and dismissed all of his direct staff.<sup>188</sup>

### *B. England*

The London Approach refers to the way the Bank of England, along with other financial institutions, led restructuring of companies and succeeded in reviving many of them when the British economy went into a depression in the 1970s.<sup>189</sup> It is an unofficial guideline that banks follow for corporate restructuring, but it does not have any underlying legal authority.<sup>190</sup>

Interested parties were invited to both private and official negotiations where they discussed issues such as corporate reorganization and composition. The Bank of England played a leading role as the main banker for debt-for-equity swaps.<sup>191</sup> It worked with the Ministry of Finance and handled negotiations with creditors to find solutions.<sup>192</sup> It actively supervised creditors and ad-

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<sup>182</sup> *Id.*

<sup>183</sup> *Id.*

<sup>184</sup> *Id.*

<sup>185</sup> *Id.*

<sup>186</sup> *Id.*

<sup>187</sup> *Id.*

<sup>188</sup> *Id.*

<sup>189</sup> See Meyerman, *supra* note 11, at 300.

<sup>190</sup> See Esteban C. Buljevich, *The Workout Decalogue: The New Global Approach to Debt Restructuring*, in CROSS-BORDER DEBT RESTRUCTURINGS: INNOVATIVE APPROACHES FOR CREDITORS CORPORATES AND SOVEREIGNS, 4–5 (Esteban C. Buljevich ed., 2005).

<sup>191</sup> See Pen H. Kent, Corporate Workouts—A UK Perspective, 6 INT. INSOLV. REV. 165 (1997), <http://onlinelibrary.wiley.com/doi/10.1002/iir.3940060302/abstract>; see also Peter Brierley & Ger-tjan Vlieghe, *Corporate Workouts, the London Approach and Financial Stability*, 7 FIN. STABILITY REV. 168, 174 (1999), <http://www.bankofengland.co.uk/archive/Documents/historicpubs/fsr/1999/fsrfull9911.pdf>.

<sup>192</sup> *Id.*

vised them on ways the companies could be revived.<sup>193</sup> The London Approach took the following path.

First, the creditors and debtors were given sufficient time to understand the London Approach and reach interim agreements to continue operations and avoid insolvency.<sup>194</sup> Under these agreements, creditors could not execute their collateral rights or seize company assets.<sup>195</sup> The leading bank or the management committee was appointed to manage problem-solving procedures and discussions.<sup>196</sup>

Second, attorneys or auditors (independent accounting firms) were appointed to investigate the insolvent companies.<sup>197</sup> The attorneys prepared documents on guarantees and collateral rights and consulted with the auditors on issues such as choosing which assets to use as collateral.<sup>198</sup> Auditors investigated the company's current operations, cash deficiency, long-term performance, existing default issue causes, strengths and weaknesses of management, and possible impact on creditors due to insolvency.<sup>199</sup>

Third, the auditors submitted a draft of a corporate restructuring proposal, which covered the debtor's possibility of surviving, potential to receive funds from existing shareholders, change of management personnel, financial status, decrease in interest rate, course for a debt-for-equity swap, and voluntary sale of assets.<sup>200</sup> The accounting firms, who were auditors, then consulted with attorneys to submit the restructuring proposal to creditors.<sup>201</sup>

Fourth, the creditors were led to agree to the proposal.<sup>202</sup> If certain banks did not agree,<sup>203</sup> the remaining banks asked the Bank of England for guidelines to the London Approach.<sup>204</sup> Unless there was a specific reason the dissenting bank(s) needed special treatment, the Bank of England generally required the opposing banks to agree to the proposal.<sup>205</sup> Although the Bank of England could not use legal measures to force them to agree to the proposal, it did have persua-

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<sup>193</sup> See Meyerman, *supra* note 11, at 301.

<sup>194</sup> See Brierley & Vlieghe, *supra* note 191, at 173.

<sup>195</sup> See Kent, *supra* note 191, at 9.

<sup>196</sup> *Id.*

<sup>197</sup> See Brierley & Vlieghe, *supra* note 191, at 173.

<sup>198</sup> *Id.*

<sup>199</sup> *Id.*

<sup>200</sup> *Id.*

<sup>201</sup> *Id.*

<sup>202</sup> See Kent, *supra* note 191, at 11.

<sup>203</sup> *Id.*

<sup>204</sup> *Id.*

<sup>205</sup> *Id.*

sive power over all England-based banks and foreign banks in England.<sup>206</sup> Thus, the opposing banks eventually agreed to follow the proposal.<sup>207</sup>

Fifth, shareholders approved the restructuring proposal.<sup>208</sup> If they agreed with it, the proposal would come into effect via a shareholders' resolution. If creditors possessed over 30% of the shares after the swap, they were obliged to engage in a takeover bid.<sup>209</sup> According to England's Takeover Code,<sup>210</sup> creditors had to engage in a takeover bid if shareholders at the shareholders' meeting did not exempt the creditors from the bid.

The London Approach helped numerous companies overcome England's financial crisis.<sup>211</sup> Companies that were successfully revived through the London Approach made agreements with creditors and promoted various restructuring strategies.<sup>212</sup> Those companies concentrated on selling assets, replacing management, and reinforcing financial management while refraining from acquiring companies and making investments.<sup>213</sup>

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<sup>206</sup> *Id.*

<sup>207</sup> *Id.*

<sup>208</sup> *Id.*

<sup>209</sup> See Colin Mayer, *Regulatory Principles and the Financial Services and Markets Act*, in REGULATING FINANCIAL SERVICES AND MARKETS IN THE 21ST CENTURY (Eilis Feran & Charles Goodhart eds., 2001), [http://users.ox.ac.uk/~ofrcinfo/file\\_links/finecon\\_papers/2001fe09.pdf](http://users.ox.ac.uk/~ofrcinfo/file_links/finecon_papers/2001fe09.pdf) ("One area in which shareholder protection differs between the U.K. and U.S. is in relation to takeovers. The Takeover Code was introduced in the U.K. to achieve fair play in takeovers and to ensure that minority investors were not disadvantaged. Unlike the U.K., the U.S. has no 30% equal price rule requiring a bid for all shares in a company once 30% of shares have been acquired.").

<sup>210</sup> See Paul L. Davies, Edmund Schuster-Philipp & Emilie van de Walle de Ghelcke, *The Takeover Directive as a Protectionist Tool?* (ECGI—Law, Working Paper No. 141/2010, 2010), [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1554616](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1554616) (scroll to bottom and click "Open PDF in Browser" or "Download this Paper"); see also MICHAEL E. HATCHARD & SCOTT C. HOPKINS SKADDEN, ARPS, SLATE, MEAGHER & FLOM (UK) LLP, *General Guide to the UK Takeover Regime* 1 (2014).

<sup>211</sup> Meyerman, *supra* note 11, at 299–319.

<sup>212</sup> Some British commentators argue that:

The U.S. insolvency regime is often quoted as an example of a debtor-oriented regime because the Chapter 11 procedure effectively allows the debtor to call a moratorium and negotiate restructuring plans, which if approved by a majority of creditors are then binding on all. Both the United Kingdom and Germany are generally regarded as examples of creditor-oriented regimes, because they facilitate the secured creditors' ability to enforce their security.

Brierley & Vlieghe, *supra* note 191, at 172.

<sup>213</sup> *Id.*



*C. United States**1. Chrysler Motors*

Chrysler became insolvent when, after recklessly expanding its production facilities beginning at the end of the 1970s, the second oil shock struck.<sup>214</sup> In the third quarter of 1979, Chrysler's losses reached \$450 million.<sup>215</sup>

The banks played a major role in the restructuring process—Chrysler's creditors consisted of about 400 banks, including the leading bank, Manufacturers Hanover Trust Co.<sup>216</sup> The creditors undertook a debt-for-equity swap by converting approximately \$1 billion—half of Chrysler's debts—into common stock and deducting approximately \$700 million in debts.<sup>217</sup>

The U.S. government supported the restructuring process by guaranteeing \$1.2 billion based on the company's internal effort.<sup>218</sup> In order to evidence such efforts, Lee Iacocca became the CEO, the company reduced production, and mid-sized vehicles replaced large vehicles for innovative purposes.<sup>219</sup> To save on costs, the company dismissed 50,000 employees over five years, reducing its work force by 45% from 110,000 to 60,000.<sup>220</sup> Finally, several overseas companies were closed, and one of the production plants was sold.<sup>221</sup>

*2. Morrison Knudsen*

In 2000, Morrison Knudsen (MK) recorded \$2 billion in sales from its gold mining, environmental, train manufacturing, and transportation businesses.<sup>222</sup> However, it failed to meet a train manufacturing contract and encountered

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<sup>214</sup> See Kim, *supra* note 52, at 36.

<sup>215</sup> *Id.* at 36–37.

<sup>216</sup> *Id.*

<sup>217</sup> In the United States, the debt-for-stock exchange originates from common law. See Michelle Arnopol Cecil, *Reinvigorating Chapter 11: The Case for Reinstating the Stock-for-Debt Exception in Bankruptcy*, 2000 WIS. L. REV. 1001, 1003 (2000) (providing some information regarding the debt-for-equity exchange), <http://scholarship.law.missouri.edu/cgi/viewcontent.cgi?article=1090&context=facpubs>. “If a corporation was either insolvent or in bankruptcy and issued stock to its creditors in exchange for indebtedness, the [financially troubled] corporation” receives benefits from the tax treatment. *Id.*

<sup>218</sup> See Kim, *supra* note 52, at 37.

<sup>219</sup> Jennifer Harrington, *Lee Iacocca: The Most Famous CEO of Chrysler*, ALLPAR, <http://www.allpar.com/corporate/bios/iacocca.html> (last visited Mar. 13, 2017).

<sup>220</sup> Kim, *supra* note 52, at 37.

<sup>221</sup> See Jerry Flint, *Company of the Year: Chrysler*, FORBES, Jan. 13, 1997, at 82, <https://www.forbes.com/forbes/1997/0113/5901082a.html>.

<sup>222</sup> Henry Owsley & Patricia Caldwell, *Client Engagement Morrison Knudsen*, GORDIAN

a cash deficiency.<sup>223</sup> Its restructuring process, with its twenty-seven creditors, proceeded as follows.

MK's first step was to support the Bridge Loan (i.e., the creditor provided emergency rescue funds).<sup>224</sup> Existing creditors received security interests in 100% of the company assets to obtain \$110 million of emergency funds while the company signed a status quo maintenance agreement to prevent bankruptcy.<sup>225</sup>

The second step of restructuring was splitting off the train manufacturing division.<sup>226</sup> While there were initially no buyers, the company eventually detached the train division, borrowed \$38 million, and opened a new credit line for \$80 million.<sup>227</sup> The company also signed a second bridge loan and contribution agreement.<sup>228</sup> MK gave subordinate collateral rights to old debts and absorbed the repayment obligations.<sup>229</sup> The new agreement between creditors gained priority over the existing agreement.<sup>230</sup>

The third restructuring step involved adjusting capital structure and selling businesses in which 100% of old debt was converted to common stock.<sup>231</sup> Old

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GROUP, <https://gordiangroup.com/clients/engagement/morrison-knudsen/> (last visited Apr. 4, 2017).

MK was a large engineering, construction and mining management services company. . . . [F]acing insolvency, [it] struck a complex deal with its banks and with its surety companies that had provided performance and completion bonds to the company. In 1995, after an unsuccessful sale process, MK transferred certain assets and contracts relating to the manufacture of mass transit vehicles for various municipalities into a newly formed limited liability company established for the benefit of the sureties. In turn, MK received cash and was released from certain financial obligations in this "spin-off" transaction that had an aggregate deal value of over \$200 million. . . . [The] Gordian Group was retained to render an opinion that the transaction was fair to certain creditors of MK. [Gordian was] selected because of [its] significant capital markets and opinion experience, and [its] ability to perform a massive amount of due diligence, valuation, solvency and other work in a very short period of time. Gordian Group's work involved examining the transaction (and the alternatives thereto), [and] the implications of a bankruptcy on the claims (secured and otherwise) of various creditors, together with the valuations and financial obligations of the other MK entities.

*Id.*

<sup>223</sup> *Id.*

<sup>224</sup> See Kim, *supra* note 52, at 32.

<sup>225</sup> *Id.* at 32–33.

<sup>226</sup> *Id.*

<sup>227</sup> *Id.*

<sup>228</sup> Baird Webel & Bill Canis, *TARP Assistance for Chrysler: Restructuring and Repayment Issues*, CONGRESSIONAL RES. SERV. (Sept. 7, 2012), <https://fas.org/sgp/crs/misc/R41940.pdf>.

<sup>229</sup> *Id.*

<sup>230</sup> *Id.*

<sup>231</sup> *Id.*

stock was retired, but shareholders received rights to repurchase shares with the premium; the company then sold assets to repay the bridge loan with unsold assets being distributed to creditors.<sup>232</sup>

The fourth restructuring step was selling the company through a merger.<sup>233</sup> The company merged with Washington Construction Group<sup>234</sup> and used stock to transfer its holdings to minimize the cash requirement. The company provided compensation if it breached contracts and paid the actual cost of due diligence to protect the purchasers.<sup>235</sup> Forty-five percent of the merger company's common stock was given to the MK creditors' committee, and warranties were given to MK shareholders who held common stock.<sup>236</sup> This process followed a "pre-packaged plan" process under Chapter 11 of the U.S. Bankruptcy Code.<sup>237</sup> Thus, existing creditors held 45% of the shares after the merger while existing MK shareholders basically lost their rights.

The last step was the creditors' collection of claims. Existing creditors received the new company's 45% common stock and excess assets<sup>238</sup> with 30–40% discounts.<sup>239</sup> In early 1997, creditors retrieved over 100% of their expected amounts by selling stock.<sup>240</sup> The overall process took twenty-one months, from January 1995 to September 1996.<sup>241</sup>

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<sup>232</sup> *Id.*

<sup>233</sup> *Id.*

<sup>234</sup> Bloomberg News, *Morrison Merging with Washington Construction*, N.Y. TIMES (Aug. 27, 1996), <http://query.nytimes.com/gst/fullpage.html?res=9A03E1DB1339F934A1575BC0A960958260>. The New York Times reported that:

The Morrison Knudsen Corporation won court approval of its bankruptcy plan yesterday, giving the company a green light to exchange its debt for equity and to merge with a rival, the Washington Construction Group. Morrison Knudsen, an engineering company, filed for bankruptcy in June, proposing to swap \$360 million of debt for new equity and other assets. Washington Construction has agreed to buy Morrison Knudsen for about \$380 million. Washington Construction, based in Highland, Calif., is controlled by a Montana billionaire, Dennis Washington, who will be chairman of the new company. The merger would be effective on September. 11. The new company, which will keep the name Morrison Knudsen, will be based in Boise, Idaho.

*Id.*

<sup>235</sup> See Marc Robins, *Fallen Angels*, FORBES, Sept. 4, 2000, at 156, <http://www.forbes.com/forbes/2000/0904/6606156a.html>.

<sup>236</sup> See Kim, *supra* note 52, at 35.

<sup>237</sup> *Id.*; see also GAUGHAN, *supra* note 17, at 446–48.

<sup>238</sup> This refers to shares of common stock under the condition that they shall be repaid to creditors upon receipt of a tax return from the government and shares of enlisted subsidiary companies.

<sup>239</sup> See Kim, *supra* note 52, at 36.

<sup>240</sup> *Id.*

<sup>241</sup> *Id.*; see app. Table 6.

*D. Korea**1. Use of Debt-for-Equity Swaps*

Workout companies in Korea mostly used the debt-for-equity swap as a financial restructuring tool. As of October 1999, about eighty companies made corporate restructuring agreements with financial institutions—the amount of workout claims reached approximately KRW 3.5 trillion.<sup>242</sup>

The Korean government strongly recommended debt-for-equity swaps to financial institutions as a method to revive companies that looked insolvent.<sup>243</sup> Among the group of companies that ranked between 6th and 64th in size at the Fair Trade Commission, those with the potential to be revived were selected for corporate restructuring agreements with workout plans that were applied to carry out the debt-for-equity swaps.<sup>244</sup> Small or medium-sized companies with weak restructuring capacities and few creditors processed debt-for-equity swaps and other types of workouts through designated individual financial institutions.<sup>245</sup>

As of June 10, 1999, the amount of debt handled in debt-for-equity swaps by workout companies was KRW 1,470.4 billion, with 82% (KRW 1,210.8 billion) in the actual swapping process.<sup>246</sup> All the companies that underwent corporate reorganization executed the debt-for-equity swap after their reorganization plans were approved.<sup>247</sup>

*2. Prochips Inc.*

Prochips Inc., which was listed on KOSDAQ, manufactures customized semiconductors.<sup>248</sup> It needed an enormous investment for its technological development, but experienced a financial crisis in 1997 because of reckless business expansion, depressed sales, and inaccurate estimation of demand for digital satellite receivers.<sup>249</sup> The company started to invest in stock to weather the crisis, but eventually suffered more losses.<sup>250</sup> Thus, the company applied for the

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<sup>242</sup> See Oh Ho-keun, *Korea's Corporate Restructuring and Debt Equity Swap of Debts*, Corporate Restructuring Committee Report 2 (1999). (S. Kor).

<sup>243</sup> *Id.*

<sup>244</sup> See Kim, *supra* note 52, at 38.

<sup>245</sup> See *id.*

<sup>246</sup> See *id.*

<sup>247</sup> See *id.*

<sup>248</sup> *Prochips Technology, Inc.*, EC21, [http://prochips.en.ec21.com/offer\\_detail/semiconductor--199910150380.html?gubun=S](http://prochips.en.ec21.com/offer_detail/semiconductor--199910150380.html?gubun=S) (last visited Mar. 13, 2017).

<sup>249</sup> See Kim, *supra* note 52, at 38.

<sup>250</sup> *Id.*

initiation of a composition in Seoul Central District Court on March 26, 2001.<sup>251</sup> According to the balance sheet from June 30, 2001, the company's total assets were approximately KRW 45,594 million, and its total debts were about KRW 72,121 million. Thus, the debts surpassed the assets by about KRW 26,527 million.<sup>252</sup>

The company determined that a composition with the old management would not solve the problem.<sup>253</sup> It therefore applied for the corporate reorganization process, in the Seoul Central District Court on June 21, 2001, to induce participation by outside investors.<sup>254</sup> For early normalization of management, every member of the company entered into an emergency management system to increase sales, improve efficiency of capital control, and strengthen the financials.<sup>255</sup>

Prochips' corporate reorganization plan was a typical third-party acquisition by a Corporate Restructuring Company (CRC),<sup>256</sup> but it was unique in that a pre-packaged reorganization plan was used successfully.<sup>257</sup> It was also significant because the court mediated between creditors and debtors before it filed the reorganization plan to save time and money.<sup>258</sup> The following describes the chronological progress of the reorganization procedure.<sup>259</sup>

As previously described, the company applied for commencement of a composition in the Seoul Central District Court on March 26, 2001 and was approved on April 24, 2001.<sup>260</sup> However, the composition was terminated on June

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<sup>251</sup> Cheolsu Kim, *Prochips Filed Corporate Reorganization Proceeding*, HANKYUNG (June 21, 2001) [hereinafter Cheolsu].

<sup>252</sup> *Id.*; see also Kim, *supra* note 52, at 38.

<sup>253</sup> The main reason for this is that non-assenting creditors were expected to enforce their claims in full at any time outside the composition agreements.

<sup>254</sup> See Kim, *supra* note 52, at 38.

<sup>255</sup> KRW 9,768,136,000 did not undergo a debt-for-equity swap by principal debtors. *Id.*

<sup>256</sup> Corporate Restructuring Company is a Korean-style "vulture fund" that specializes in insolvent companies' assets and securities and subsequent corporate restructuring. According to Korean law, CRC is defined as "a company whose main duty is to acquire restructuring companies and normalize its management and sell acquired companies." Sahn up bahl juhn beob [Industrial Development Act], Act. No. 5825, Feb. 8, 1999, art. 14 (S. Kor.), [https://elaw.klri.re.kr/kor\\_service/lawView.do?hseq=5044&lang=ENG](https://elaw.klri.re.kr/kor_service/lawView.do?hseq=5044&lang=ENG).

<sup>257</sup> See 11 U.S.C. § 1126 (2012).

<sup>258</sup> ROSS ET AL., *supra* note 12, at 410–11 (discussing Covad Communications filing a Chapter 11 case under the U.S. Bankruptcy Code on Aug. 15, 2001).

<sup>259</sup> *Id.*

<sup>260</sup> The term composition means "a financial agreement between an insolvent debtor and its creditors. A composition presupposes that the debtor is experiencing difficulties in meeting its financial commitments. Creditors must consider they have no option but to waive a portion of their claims." *Composition*, ACKORDSCENTRALEN, <http://ackordscentralen.se/eng/composition> (last visited Mar. 14, 2017).

20, 2001, to induce new investors to participate and was converted to a corporate reorganization process because the existing holdings of the current president prevented investments under the composition from becoming beneficial. On June 29, 2001, the court rendered provisional remedies<sup>261</sup> regarding corporate assets and commenced the corporate reorganization process on July 13, 2001.<sup>262</sup>

The company formed contracts to make new investments on November 15, 2001.<sup>263</sup> Specifically, Golden Bridge, CRC's corporate restructuring union, and Hyeonwoo Macplus Inc. processed a paid-in capital increase and bridge loan through the third-party distribution of new shares and acquired the company for KRW 29.5 billion.<sup>264</sup> The total number of existing shares was retired by a 20:1 capital decrease, and about KRW 15.5 billion (par value of KRW 500) was brought in to acquire new stock.<sup>265</sup> Another KRW 13 billion was brought in through the Bridge Loan.<sup>266</sup> On November 21, 2001, the court approved the corporate reorganization plan containing these provisions.<sup>267</sup>

The reorganization plan was based on a merger and acquisition for revival and chose acquisition proceeds<sup>268</sup> through the M&A and sale of existing real estate as the major source of capital to make repayments to creditors. The company also abolished unprofitable businesses and adjusted factory operations to achieve early normalization. The reorganization plan focused on the following.

a. The Key Element of the Reorganization Plan

(i) *Investment Agreements to Acquire the Reorganizing Company*

The acquisition was completed through a paid-in capital increase and a bridge loan through a third-party distribution of new stock.<sup>269</sup> The acquirers were Golden Bridge and Hyeonwoo Macplus Inc.<sup>270</sup> The total amount of acqui-

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<sup>261</sup> The provisional remedies were necessary because Korean bankruptcy law did not adopt U.S. bankruptcy law's "automatic stay." Due to the automatic stay, once a corporation files for Chapter 11, the corporate assets are given a provisional remedy. That remedy provides for all payments on principal and interest to be discontinued and prohibits secured creditors from exercising their rights against the collateral. See 11 U.S.C. § 362.

<sup>262</sup> See Kim, *supra* note 52, at 38–48.

<sup>263</sup> *Id.*

<sup>264</sup> *Id.*

<sup>265</sup> *Id.*

<sup>266</sup> *Id.* Hyeonwoo Macplus Inc., the prospective acquirer, agreed to borrow KRW 13 billion from KDB Loan Star CRC, to be repaid on January 31, 2002, with fixed interest (9% per year until December 24, 2001 and 10% per year until January 31, 2002) and to lend it to Prochips Inc. *Id.*

<sup>267</sup> See Kim, *supra* note 52, at 41.

<sup>268</sup> This is called "fresh money," "new money," or "new value." *Id.*

<sup>269</sup> *Id.*

<sup>270</sup> See *id.*

sition proceeds was KRW 29.5 billion (KRW 15.5 billion from new shares and KRW 14 billion from the bridge loan).<sup>271</sup> The changes in the rights and repayment schedule for secured and unsecured claims after the acquisition did not specify a grace or installment period, but arranged for a one-time repayment by waiving claims or reducing debt in a debt-for-equity swap.<sup>272</sup> The repayment sources came from the sale of real estate, loans, and operating profits.<sup>273</sup>

*(ii) Change in Shareholder Rights and Issuance of New Shares*

Shareholders' rights were strongly restricted by the reorganization plan. No dividends or voting rights were allowed.<sup>274</sup> To decrease capital, the controlling shareholders' 681,435 shares and the company's one million shares were retired without compensation, and all other stock was reduced by a 20:1 ratio.<sup>275</sup> Old stock certificates were submitted within one month of the approval of the reorganization plan.<sup>276</sup> The capital decrease was effective when the stock certificate submission period expired.<sup>277</sup>

Thirty-one million new shares were issued at KRW 500 par values with "Small and Medium size Venture Company Competition Reinforcement Union No. 1."<sup>278</sup> The corporate restructure union of Hyeonwoo Macplus Inc. and Golden Bridge CRC purchased the new shares, which were validated a day after the capital decrease became effective.<sup>279</sup> 3,879,005 new shares were issued, at KRW 500 par value, through the debt-for-equity swap.<sup>280</sup> The total amount of new shares was KRW 1.94 billion.<sup>281</sup> The value of the debt-for-equity swap was KRW 5,000 for loans constituting the secured claims, KRW 10,000 for lease secured claims, and KRW 13,000 for loan unsecured claims.<sup>282</sup> New shares were validated a day after the capital decrease became effective.<sup>283</sup>

**b. Management of Reorganized Company After Acquisition**

The company sold its non-operating assets and closed unprofitable busi-

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<sup>271</sup> *Id.* at 41–42.

<sup>272</sup> *Id.*

<sup>273</sup> *Id.*

<sup>274</sup> *Id.*

<sup>275</sup> *Id.*

<sup>276</sup> *Id.*

<sup>277</sup> *Id.*

<sup>278</sup> *Id.*

<sup>279</sup> *Id.*

<sup>280</sup> *Id.*

<sup>281</sup> *Id.*

<sup>282</sup> *Id.*

<sup>283</sup> *Id.*

nesses.<sup>284</sup> The organization was restructured, and its market was diversified.<sup>285</sup> The company concentrated on the research and development of a digital set-top box and a LCoS and Organic LED, a new-generation display device.<sup>286</sup>

When the company repayed all of its debts to the satisfaction of the reorganization plan, the receiver requested that the corporate reorganization process be terminated and the court approved the termination.<sup>287</sup>

c. Agreement of Capital Decreases and Paid-in Capital Increase (Nov. 23, 2001)

The capital decrease was mostly processed as a sanction for the insolvency.<sup>288</sup> In this case, shares of old stock, which were owned by the majority shareholder, were reduced by a 20:1 ratio.<sup>289</sup>

d. Agreement of Stock Retirement (Nov. 23, 2001)

A capital decrease generally constitutes the preparation process for a debt-for-equity swap; it requires a special resolution at the shareholders' meeting. However, when the Corporate Reorganization Act (KCRA), the current DRBA equivalent, comes into play, the court decides on a capital decrease without the resolution, and 100% of old stock is subjected to the capital decrease rate.<sup>290</sup> The company's capital becomes "0" for an instant.<sup>291</sup> Thus, to prevent this, the capital decrease rate is generally set to "100% for controlling shareholders and 95% for general shareholders."<sup>292</sup>

e. Agreement for Paid-in Capital Increase (Nov. 23, 2001)

Parties executed the debt-for-equity swap at this stage.<sup>293</sup> To prevent incoming "fresh money" from undergoing a capital decrease, the company cut down its capital in advance, with most of the incoming capital after the debt-for-equity swap being used to repay the old company's debts and the cost of the

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<sup>284</sup> *Id.*

<sup>285</sup> *Id.*

<sup>286</sup> *Id.*

<sup>287</sup> *Id.*

<sup>288</sup> *Id.*

<sup>289</sup> *Id.* at 43.

<sup>290</sup> *Id.* at 44.

<sup>291</sup> *Id.*

<sup>292</sup> *Id.* Here, the Capital Decrease amounted to 681,435 shares being held by controlling shareholders and special interested parties, one million company shares were retired, and the remaining 28,581,925 shares were reduced by the ratio of 20:1. *Id.*

<sup>293</sup> *Id.*



debt-for-equity swap.<sup>294</sup> The remaining capital was given to the new company for operating costs.<sup>295</sup> The amount of the debt-for-equity swap (KRW 5,000/KRW 10,000/KRW 13,000) varies because the repayment of debt is graded according to the nature of the debt.<sup>296</sup>

f. Changes in Majority or Controlling Shareholders (Dec. 22, 2001)

When a debt-for-equity swap is completed, the acquirer becomes the new leading shareholder. The company must immediately notify the Korea Stock Exchange and follow related regulations, such as the Stock Exchange Act.<sup>297</sup>

g. Application and Decision to Terminate Corporate Reorganization Process (Dec. 28, 2001)

When the repayment of debts satisfied the corporate reorganization plan, a motion to terminate the corporate reorganization proceeding was submitted to the court.<sup>298</sup> The corporate reorganization plan's feasibility was investigated so as to terminate the proceeding.<sup>299</sup>

#### IV. DEBT-FOR-EQUITY SWAP PROCEDURES

It is necessary for the creditors to share the burden of a financially troubled company so that the company can be revived.<sup>300</sup> This is not a creditor's sacrifice or yielding to the debtor, but a strategy to revive the company for the creditor's own benefit. In this case, creditors can convert their investments and loan claims into equity in the company and directly affect the company's financial restructuring in positive ways.

After incorporation, a company can issue new shares via resolutions approved at a board of directors meeting to change the corporation's capital structure.<sup>301</sup> Persons receiving new shares must state legal provisions on two copies of the president's Subscription Form for New Stock and make an offer.<sup>302</sup> The

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<sup>294</sup> *Id.*

<sup>295</sup> *Id.*

<sup>296</sup> *Id.* at 45.

<sup>297</sup> *Id.* at 47 (modified by Capital Market and Financial Investment Business Act, No. 12383).

<sup>298</sup> *Id.*

<sup>299</sup> *Id.*

<sup>300</sup> In general, distribution and collection rates are high.

<sup>301</sup> See GAUGHAN, *supra* note 17 **Error! Bookmark not defined.**, at 224 ("Issuing more share . . . increases equity while maintaining the current level of debt.").

<sup>302</sup> Sangbeob [Commercial Act], Act No. 1000, Jan. 20, 1962, *amended by* Act No. 10696, May 23, 2011, arts. 420, 425, 302(3) (S. Kor.), translated in Korea Legislation Research Institute online database, [http://elaw.klri.re.kr/eng\\_service/main.do](http://elaw.klri.re.kr/eng_service/main.do) (login and search required).

subscriber is obliged to pay for the number of shares received.<sup>303</sup> In debt-for-equity swaps, the subscription fee substitutes for the non-performed loan, to avoid payment.

*A. Board's Agreement to Issue New Shares*

Unlike a general new stock issuance, a debt-for-equity swap is actually a method of paid-in capital increase through third-party distribution of new stock (i.e., a type of subscription price consideration that does not require actual payment).

Even if the bylaws have special provisions and a company already has agreements to provide third parties with preemptive rights to new stock based on bylaws,<sup>304</sup> the board of directors determines whether to issue shares to third parties.<sup>305</sup> In other words, the board generally considers the company's financial situation, the stock exchange market, and the need to make strategic partnerships to determine whether and when to issue new shares to third parties.<sup>306</sup>

When the board decides to issue new shares to third parties, unless the bylaws contain special provisions, a few other issues must be decided. If the corporation is going through a reorganization procedure, these decisions must be mentioned in the reorganization plan.<sup>307</sup> The following issues are examined when selecting creditors as investees.<sup>308</sup>

*B. Selection of Subject Creditors of a Debt-for-Equity Swap*

Creditors and companies may discuss the desirability of a debt-for-equity swap or creditors alone can choose to do a debt-for-equity swap.<sup>309</sup> In any case,

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<sup>303</sup> *Id.* arts. 421, 425, 303.

<sup>304</sup> 12 C.F.R. § 7.2021 (2016).

<sup>305</sup> Sangbeob [Commercial Act], Act No. 1000, Jan. 20, 1962, *amended by* Act No. 10696, May 23, 2011, art. 416 (S. Kor.), translated in Korea Legislation Research Institute online database, [http://elaw.klri.re.kr/eng\\_service/main.do](http://elaw.klri.re.kr/eng_service/main.do) (login and search required); *see also* Clarendon Group, Ltd. v. Smith Labs., Inc., 741 F. Supp. 1449, 1453 (S.D. Cal. 1990) (In general, “[c]orporations were granted the power to limit or deny preemptive rights in their articles of incorporation.”).

<sup>306</sup> CLIFFORD R. ENNICO, CLOSELY HELD CORPORATIONS: FORMS AND CHECKLISTS § 3:41 (2016). (“Articles of incorporation frequently include a clause concerning the preemptive rights of shareholders—that is, the right of shareholders to purchase new issues of stock by the corporation in proportion to their holdings of existing stock.”).

<sup>307</sup> *See generally What Every Investor Should Know*, SEC (Feb. 3, 2009), <https://www.sec.gov/investor/pubs/bankrupt.htm>.

<sup>308</sup> “If a minority shareholder holds ‘substantive participating rights,’ then the presumption that the majority shareholder should consolidate the investee’s balance sheets is rebutted.” *In re Vivendi Universal, S.A.*, 381 F. Supp. 2d 158, 178 (S.D.N.Y. 2003).

<sup>309</sup> It seems odd that creditors can unilaterally make this decision as it would seemingly give a

the creditors consider whether the company has the potential for revival once its debts are reduced.

The following are criteria for the selection of debt-for-equity swaps. First, the company must have the potential to be revived when its financing costs are waived or considerably reduced, which means that the current cash flow from business operations must be larger than the liquidation value.<sup>310</sup> Second, the company's business operations must be normal even though its debts and financing costs are excessive. Third, the company must be open to third party acquisitions. Fourth, the company must be technologically competitive and have a good brand image. Finally, management and the majority shareholders must endorse a debt-for-equity swap or capital decrease.

### *C. Decision Regarding the Debt-for-Equity Swap Rate*

The debt-for-equity swap rate has a critical impact on the interests of fi-

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large enough creditor the right to take over a company at any time, even if the debt is not in default; so this should apply only to creditors of insolvent companies.

<sup>310</sup> The cash flow used in the calculation of the going concern value of the corporation refers to the free cash flow (FCF) to the firm. See PABLO FERNANDEZ, VALUATION METHODS AND SHAREHOLDER VALUE CREATION 40, 171, 600 (2002). The FCF is derived by adjusting non-capital expenses such as income tax and depreciation, as well as capital expenditure and additional working capital to earnings before income tax (EBIT). See TIM KOLLER, MARC GOEDHART & DAVID WESSELS, VALUATION: MEASURING AND MANAGING THE VALUE OF COMPANIES 164 (4th ed. 2005). Calculation of FCF begins with the corporation's balance sheet and cash flow statement. The formula is as follows:  $FCF = EBIT (1 - \text{Corporate tax rate}) + (\text{Non-capital expenses}) - (\text{Capital expenditure}) - (\text{Additional working capital})$ . It can be represented differently as follows:  $FCF = (\text{Net operating profits less adjusted taxes}) + (\text{Noncash operating expenses}) - (\text{Investments in invested capital})$ . See *id.* at 160, 178. FCF is meant to measure the amount of money currently spent, rather than transactions that happened in the past. See ALFRED M. KING, VALUATION: WHAT ASSETS ARE REALLY WORTH 40 (2002). FCF is the cash flow before the repayment of the interest and after tax and principal on the debts; this is because it is the cash flow that belongs to all the parties who hold the right of claims and equity holders. See KOLLER *et al.*, *supra* note 310, at 164. "The FCF is the operating cash flow that is generated by operation, without taking into account borrowing, after tax." KING, *supra*, note 310, at 40. Therefore, FCF is not affected by the size of the corporation's debts. However, the present value—as the WACC changes according to the ratio of the debt retention—which is subject to change. Without a regulatory standard for determining FCF, investors often disagree on exactly which items should or should not be treated as capital expenditures. See Ben McClure, *What is Free Cash Flow?*, INVESTOPEDIA, <http://www.investopedia.com/articles/fundamental/03/091703.asp> (updated Feb. 29, 2016). The expected rising rate of prices affects the corporate value by changing the nominal cash flow and the nominal discount rate. "In choosing an appropriate discount rate, most U.S. courts now refer to the price-earning ratios which is the company's stock price divided by a company's earnings per share in the same business as the reorganized corporation." Elizabeth Jane Schwartz, *Inflation and the Concept of Reorganization Value*, 34 VAND. L. REV. 1727, 1736 (1981). For a corporation to continue to achieve the expected profit, the current operating assets must be maintained at their current state, which calls for constant capital expenditures.

nancial institutions and concerned companies.<sup>311</sup> Therefore, the debt-for-equity swap rate is generally decided via negotiations between companies and financial institutions. The basis for the negotiations is set by corporate investigation or due diligence and an insolvency assessment made by a professional accounting firm.<sup>312</sup> The debt-for-equity swap rate must be set so that the expected profit from the debt-for-equity swap is larger than a creditor's potential earnings from holding onto claims against an insolvent entity.<sup>313</sup> However, excessive emphasis on creditors' interests may lead to disagreements about the debt-for-equity swap plan.<sup>314</sup>

The swap rate can be decided reasonably based on how interest rates are set by the market.<sup>315</sup> However, the swap rate cannot be specified in the reorganization plan because the market and business environment change.

#### *D. Capital Decrease for Debt-for-Equity Swap*

In order to carry out a debt-for-equity swap, corporate assets must be investigated, and the capital decrease must be processed if a capital deficiency exists. If an investigation shows no equity encroachment, the debt-for-equity swap applies a market price or par value. On the other hand, if the entire equity capital is cannibalized, in part or in whole, a debt-for-equity swap shall be processed after a partial or complete capital decrease.<sup>316</sup> Creditors may object to capital decreases. In such cases the company shall repay the claims or give a considerable amount of collateral to the creditors. Creditor cooperation is critical.

The decision to engage in a capital decrease requires a special resolution at the shareholders' meeting.<sup>317</sup> In this meeting, at least two thirds of the voting shareholders must be present, and the resolution must receive at least one third

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<sup>311</sup> Buttonwood, *What's Wrong with Finance*, THE ECONOMIST (May 1, 2015), <http://www.economist.com/blogs/buttonwood/2015/05/finance-and-economics>.

<sup>312</sup> See Kim, *supra* note 52, at 50.

<sup>313</sup> The exact ratio of swap rate may not be determinable until exact valuation by insolvent firms have been made. See GAUGHAN, *supra* note 17, at 498 (describing marketability of the stock).

<sup>314</sup> David N. Crapo, *Using a Debt-for-equity Swap to Acquire a Distressed Company*, GIBBONS L. (Apr. 7, 2009), <http://www.gibbonslaw.com/using-a-debt-for-equity-swap-to-acquire-a-distressed-business-the-constar-international-bankruptcy-as-a-case-in-point-04-07-2009/>.

<sup>315</sup> "[T]he capital structure of the [insolvent company] might feature adjustable interest rate, which may have a significant impact of the projected net cash flow, depending on how interest rates vary." GAUGHAN, *supra* note 17, at 309.

<sup>316</sup> One method of capital decrease is stock redemption. *Capital Reduction*, Investopedia, <http://www.investopedia.com/terms/c/capitalreduction.asp> (last visited Apr. 10, 2017).

<sup>317</sup> Sangbeob [Commercial Act], Act No. 1000, Jan. 20, 1962, *amended by* Act No. 10696, May 23, 2011, art. 438(1) (S. Kor.), translated in Korea Legislation Research Institute online database, [http://elaw.klri.re.kr/eng\\_service/main.do](http://elaw.klri.re.kr/eng_service/main.do) (login and search required).

of the total issued and outstanding shares' affirmative votes.<sup>318</sup> A complete capital decrease is rarely approved by the shareholders and may cause problems with a debt-for-equity swap.

Some companies engage in the corporate reorganization process, or those with approved reorganization plans theoretically drop their stock value to zero. In this case, even though shareholders may participate in the reorganization proceeding, shareholders cannot exercise their voting rights<sup>319</sup> because when the total liabilities of a company exceed its total assets at the commencement of the reorganization proceeding, the shareholders are not permitted voting rights.<sup>320</sup> In this case, a debt-for-equity swap shall be decided in a creditors' general meeting only by secured<sup>321</sup> and unsecured reorganization creditors.<sup>322</sup> This is because creditors are the actual owners of the company. However, if the balance sheet shifts to the extent that assets are greater than liabilities, equity exists and shareholders can vote.<sup>323</sup>

#### *E. Issuing New Shares*

Before undergoing a debt-for-equity swap to resolve the problems of a nonperforming loan, the type, class, and number of new shares must be determined. If the company is undergoing a corporate reorganization process, its reorganization plan must mention the debt-for-equity swap.<sup>324</sup> When the board of directors decides on the value of the new shares,<sup>325</sup> the following issues shall be taken into consideration.

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<sup>318</sup> *Id.* art. 434.

<sup>319</sup> Chaemuja hoebog mit pasanbeob [Debtor Rehabilitation and Bankruptcy Act], Act. No. 7428, Mar. 31, 2005, *amended by* Act. No. 12892, Dec. 30, 2014, 146(1) (S. Kor.), [http://elaw.klri.re.kr/eng\\_service/lawView.do?hseq=33349&lang=ENG](http://elaw.klri.re.kr/eng_service/lawView.do?hseq=33349&lang=ENG).

<sup>320</sup> *Id.* art. 146(3).

<sup>321</sup> The secured creditors in the plan of reorganization shall have voting rights proportionate to the value of the object of their collateral, and if the value of the claim secured is smaller than that of the object of the security, then they will be proportionate to the value of the claim secured. *See id.* art. 141(5).

<sup>322</sup> The unsecured creditors shall have voting rights in proportion to the amount calculated pursuant to the provisions of Articles 134 through 138 of the DRBA in respect to claims prescribed in these Articles, and in respect to other claims, rights in proportion thereto. *See id.* art. 133(2).

<sup>323</sup> *Id.* art. 146(3).

<sup>324</sup> *Id.* art. 265(1).

<sup>325</sup> Sangbeob [Commercial Act], Act No. 1000, Jan. 20, 1962, *amended by* Act No. 10696, May 23, 2011, art. 416(2) (S. Kor.), translated in Korea Legislation Research Institute online database, [http://elaw.klri.re.kr/eng\\_service/main.do](http://elaw.klri.re.kr/eng_service/main.do) (login and search required).

### 1. Principle of Issuing on Market Value

As existing shareholders' preemptive rights<sup>326</sup> to new stock are excluded under Article 225 Clause 2 of the KCRA when new shares are issued, the value of the new shares must consider the existing shares and their fair value.<sup>327</sup> The value set should lead the company to successful financing; be based on the company's assets, profitability, and management capacity; and be the most beneficial to existing shareholders.

Giving a fair value to new shares is the only way to preserve the existing shareholders' equity value. If the new shares are remarkably lower in value than existing shares, the existing shareholders may demand that the company stop issuing new shares<sup>328</sup> or file a petition to nullify their issuance.<sup>329</sup> The bylaws, which permit issuance of new shares through third-party distribution by limiting shareholders' preemptive rights to new shares, do not permit the issuance of shares at an unfair value.

### 2. Issuance of Shares at Below Par Value

In the case of a debt-for-equity swap regarding a nonperforming loan, whether the new shares can be issued at a price below the par value may be an issue. For example, if the market price of the shares is lower than the par value, a third party may acquire new shares at market value. However, the value of new shares can be set below the par value; there are actual examples of such cases.<sup>330</sup> Based on the principle of capital adequacy, the company must be at

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<sup>326</sup> *Id.* art. 418(1); see ROSS ET AL., *supra* note 12, at 206 ("The purpose [of preemptive rights] is to give shareholders the opportunity to protect their proportionate ownership in the corporation."). See also *Clarendon Group, Ltd. v. Smith Laboratories, Inc.*, 741 F.Supp. 1449, 1453 (S.D. Cal. 1990).

<sup>327</sup> Fair Value is a legal term applied to certain transactions which serves as the legal standard in cases where stock owners have different opinions on value. WILLIAM F. SHARPE, *INVESTMENTS* 300 (1978). If the minority concerned parties are forced to receive shares at an inappropriately low price when the reorganizing corporation is merged or sold, they are given the right to receive the fair value of the stock. Model Business Corporation Act § 13.01(3)(ABA 1984). In other words, the "Fair Value" refers to the appropriate price that serves as the legal standard—this is not clear in the mutual interests. See Jongho Kim, *Bankruptcy Law Dilemma: Appraisal of Corporate Value and Its Distribution in Corporate Reorganization Proceedings*, 29(1) NW. J. OF INT'L L. & BUS. 155–57 (2009); see also GAUGHAN, *supra* note 17, at 566.

<sup>328</sup> If a company is to issue shares in violation of the Acts, subordinate statutes, or certificates of incorporation, or otherwise in a remarkably unfair manner so that shareholders are likely to suffer disadvantages thereby, such shareholders may demand that the company stop such issuance. See KCA art. 424.

<sup>329</sup> *Id.* art. 429.

<sup>330</sup> Haekshim Teletech Inc., a company listed on the Korea Stock Exchanges, implemented a paid-in capital increase for third party distribution at the price of KRW 2,790 for every KRW 5,000

least two years old and obtain court approval based on the shareholders' special resolution.<sup>331</sup> However, companies with enlisted stock certificates or registration at KSE or KOSDAQ do not need court approval.<sup>332</sup>

### 3. *Payment for New Stock*

When a debt-for-equity swap is used in a nonperforming loan situation, payment of the subscription price for new shares must be made on a designated date.<sup>333</sup> However, no actual date of subscription price payment is set by statute.<sup>334</sup> In reality, the board of directors will determine the loan amount, as of a certain date, and substitute the subscription price payment for it. The board's agreement on a certain date becomes the actual payment date, effective for the new shares received from the debt-for-equity swap of the loans.<sup>335</sup>

### 4. *Acquisition of New Stock*

In the "case where a company issues shares after its" incorporation, the "method of subscribing for new shares" that are not provided for in the certificate of incorporation shall be determined by the board of directors.<sup>336</sup> The board shall discuss each related financial institution to determine in what method new shares will be distributed to the third party.<sup>337</sup>

### 5. *Names of Investors, etc.*

When a third party with preemptive rights to new shares makes an in-kind investment, the board of directors shall determine the name(s) of the person(s) who is to make a contribution-in-kind; the class, quantity, and value of such property; and the class and number of shares to be given therefor.<sup>338</sup>

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of par value to induce new investors. See Mar. 13, 2002, KSE Disclosure.

<sup>331</sup> KCA art. 417; KSEA art. 191–15.

<sup>332</sup> KSEA art. 191–15.

<sup>333</sup> Cf. Press Release Banca Monte Dei Paschi Di Siena, *Pursuant to Article 102 of Legislative Decree No. 58 of February 24, 1998*, 1–11 (Nov. 15, 2016), [http://www.emarketstorage.com/storage/20161115/20161115\\_22792.3580545.pdf](http://www.emarketstorage.com/storage/20161115/20161115_22792.3580545.pdf) (announcing "NPL Portfolio" through a securitization transaction pursuant to Italian Law 130/1999).

<sup>334</sup> *Id.*

<sup>335</sup> KCA art. 423, cl. 1.

<sup>336</sup> *Id.* art. 416.

<sup>337</sup> *Id.* art. 416(3)

<sup>338</sup> *Id.* art. 416(4).

### 6. *Third Parties' Transfer of Preemptive Rights to New Stock*

Because preemptive rights to new stock may be transferred to third parties, the board of directors may decide the issue of transferability.<sup>339</sup> However, an argument might be raised that these preemptive rights may not transfer to third parties and the board of directors may not decide this issue.<sup>340</sup>

#### *F. Designation and Public Notice of Record Date for Allotment*

In the case of a typical paid-in capital increase, the company shall notify the holders of preemptive rights of the class and number of shares subject to such preemptive rights.<sup>341</sup> They shall also be notified of the transferability of their preemptive rights to new shares.<sup>342</sup> The notification must be sent at least two weeks prior to the subscription date.<sup>343</sup> If the debt-for-equity swap is actually run by a third-party allotment—the financial institutions and the subjects of the debt-for-equity swap are already specified by the bylaws or the preemptive rights granting agreement—notification of the new stock allotment may not be necessary.<sup>344</sup> Thus, no additional preemptory notice to the holders of preemptive rights is necessary.

#### *G. Subscription and Allotment*

A person or entity, including any financial institution, who intends to subscribe to shares by a debt-for-equity swap shall complete and sign two copies of the free-type subscription form stating the class and number of shares to which that the person is subscribing and his or her name and address.<sup>345</sup> All required information shall be provided on this subscription form.<sup>346</sup> However, for a debt-for-equity swap, the board of directors decides the amount of investment, the period, and the creditors, and if no particular subscription date exists, the sub-

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<sup>339</sup> David Yu & Bernie Liu, A Study on the Application of Preemptive Right, LLINKS CORPORATE BULLETIN (Apr. 2010).

<sup>340</sup> *Id.*

<sup>341</sup> KCA art. 419, cl. 1 ¶ 1 (Their rights shall be forfeited if they fail to apply for the subscription for new shares on or before a fixed date.). *But see supra* notes 305–06 and accompanying text.

<sup>342</sup> *Id.* art. 419, cl. 1 ¶ 2. Because the “[p]reemptive rights give shareholders a preference in buying newly issued stock over non-shareholders, thus they discriminate against non-shareholders in favor of shareholders.” *See Bank of N.Y. Co. v. Irving Bank Corp.*, 142 Misc. 2d 145, 149 (Sup. Ct. 1988) (citing 3 White, *New York Corporations*, ¶ 622.01 at 6–528).

<sup>343</sup> KCA art. 419, cl. 3.

<sup>344</sup> *Id.* art. 418, cl. 4.

<sup>345</sup> *Id.* art. 425, cl. 1; art. 302, cl. 1.

<sup>346</sup> *Id.* art. 420.



scription date.<sup>347</sup>

#### *H. Payment and Performance*

Third parties who receive new shares shall make payment, in full, on the payment date.<sup>348</sup> In the case of third parties' in-kind investment, the subject of the investment shall be transferred on the payment date and all documents required for registration, recordation, and filing to secure the title or which are required for the conveyance shall be delivered.<sup>349</sup>

Normally, if a person who has subscribed to new shares fails to pay the subscription price or to perform the contribution-in-kind on or before the date set for the payment, his or her rights shall be forfeited.<sup>350</sup> However, as a debt-for-equity swap does not require actual payment and performance, creditors receive their legal rights as shareholders without any payment.

### V. LEGAL PRINCIPLES OF A DEBT-FOR-EQUITY SWAP

The course of a debt-for-equity swap varies from legislature to legislature, but countries that follow the civil law system insist that the in-kind investment method be used.<sup>351</sup> A subscription price payment by set-off can also be used,<sup>352</sup> or the creditors can make an actual payment and get reimbursement when new shares are issued or there is a capital exchange.<sup>353</sup> The in-kind investment method is often used in Germany and Japan,<sup>354</sup> although a legal issue exists regarding whether claims can be the subject of in-kind investment. Capital exchange is mostly used in Germany to avoid in-kind investments<sup>355</sup>—this does not corre-

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<sup>347</sup> *Id.*

<sup>348</sup> *Id.*

<sup>349</sup> *Id.* art. 425; art. 305, cl. 3; art. 295, cl. 2.

<sup>350</sup> *Id.* art. 423, cl. 2.

<sup>351</sup> See Martin Karollus, *Zeitschrift für Wirtschaftsrecht*, ZIP, [Review of Business Law] 90, (Apr. 29, 1994)(Ger.).

<sup>352</sup> See Cheolsong Lee, *Dae-chul-chae-kwuan-eui-chul-ja-jeon-hwan-ea-dae-han-pub-jeok-jaeng-jeom* [The Legal Issue under the Debt Equity Swap of Loaned Claims], 266 Human Rights & Justice 27 (Korean Bar Association 1998)(S. Kor.).

<sup>353</sup> See Peter Ulmer, *Verdeckte Sacheinlage im Aktien- und GmbH-Recht* [Concealed in-kind investment in stock and limited liability company law], in ZHR, at 135 (1990)(Ger.).

<sup>354</sup> See Hiteki, *supra* note 60, at 32.

<sup>355</sup> See Dorothee Einsele, *Verdeckte Sacheinlage Grundsatz der Kapitalaufbringung und Kapitalerhaltung* [Principle of Capital Application and Maintenance of Capital], 41 NEUE JURISTISCHE WOCHENSCHRIFT [NJW] 2681, 2681 (1996) (Ger.), <https://beck-online.beck.de/Dokument?vpath=bibdata%2Fzeits%2Fnjw%2F1996%2Fcont%2Fnjw.1996.2681.1.htm&showParallelFunds tellenReadable=False>.

spond to a debt-for-equity swap.

As subscription price payment by set-off is prohibited by Article 334 of the KCA, we must consider whether subscription price payment by set-off violates the capital adequacy or full payment of consideration requirements. Requiring that creditors make payments before receiving claims is rare in relation to the debt-for-equity swap, because companies may fail to repay their claims and the creditors would have to find other financial payment sources.<sup>356</sup> As no claim can exist when a company is being incorporated, stock prices cannot be converted into claims against a company.<sup>357</sup> Therefore, the debt-for-equity swap of claims occurs in cases of capital increase by the issuance of new stock.

### *A. Method of Debt-for-Equity Swap*

#### *1. In-Kind Investment Theory*

There is dispute over whether claims can be the subject of in-kind investment. Legal systems based on European civil law, including the KCA, prohibit subscription price payment by set-off and generally perform the debt-for-equity swap using the in-kind investment method.<sup>358</sup> In detail, the creditors make an in-kind investment using their loan claims with the company, providing new shares in exchange for their rights to claims.<sup>359</sup> The debt-for-equity swap is a type of “in-kind investment of debts,” but the KCA does not acknowledge “conversion of debts into stocks.”<sup>360</sup> Therefore, an in-kind investment system shall be borrowed to make up a legal process.<sup>361</sup> The claims the company received as in-kind investment from the creditors disappear in the merger along with debts,<sup>362</sup> and the company’s balance sheets convert debt into capital.<sup>363</sup>

Investments in-kind require a certain inspection process. The purpose of inspection is meant to determine the true value of the in-kind investment and prevent its overvaluation in order to comply with the principle of corporate capi-

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<sup>356</sup> *Id.*

<sup>357</sup> *Id.*

<sup>358</sup> See Karollus, *supra* note 351, at 90. Japan also uses the in-kind investment method. *Id.*

<sup>359</sup> *Id.*

<sup>360</sup> See Commercial Act of Korea (Act No. 1000 of Jan. 20, 1962, as last amended by Act No. 13523 of Dec. 1, 2015).

<sup>361</sup> See Jun Harizuka, *Ga-si-ta-si-sai-gen-sai-ron [Debt Equity Swap Reargument]*, 16 SHOJI HOMU 1632 (2002) (Jap.).

<sup>362</sup> A merger happens if a claim and the corresponding obligation become vested in one and the same person, in which case the claim shall be extinguished. See Minbeob [Civil Act], Act no. 471, Feb. 22, 1958, amended by Act. No. 11728, Apr. 5, 2013, art. 507 (S. Kor.).

<sup>363</sup> See *infra* Tables 2–3.

tal adequacy.<sup>364</sup> In reality, however, the substantial value of a financially troubled company's loan claims is often lower than the face value, and the value must be reduced in case of a debt-for-equity swap. If capital were considered at its face value, it would likely become an overvalued, in-kind investment. Thus, the inspector would fail to determine its real value in the inspection process and would be obliged to pay the difference afterwards.<sup>365</sup> This is why in-kind investment is often something to avoid in the debt-for-equity swap, and why Korea depends on subscription price payment by set-off instead of in-kind investment.

In Germany, a cash exchange is accepted as a hidden type of in-kind investment.<sup>366</sup> The cash exchange is referred to as a pecuniary contribution in the bylaws, but companies and contributors actually intend to make in-kind investments rather than pecuniary contributions.<sup>367</sup> In other words, the company and its contributors receive a pecuniary contribution instead of an in-kind investment and the company purchases assets from contributors using the contribution. This is used by limited liability companies in Germany<sup>368</sup> and is equivalent to ex post facto incorporation in KCA.<sup>369</sup> However, the ex post facto incorporation provision does not apply *mutatis mutandis* to a capital increase by issuance of new stock.<sup>370</sup> This method requires creditors to find other financial sources to make payments on the subscription price. Furthermore, there is no difference between a cash exchange and having reimbursed contributions after payment. The maker of the contribution becomes the debtor's tenant in common property

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<sup>364</sup> See STEPHEN A. ROSS, RANDOLPH W. WESTERFIELD, & BRADFORD D. JORDAN, FUNDAMENTALS OF CORPORATE FINANCE 27 (6th ed. 2003) ("The values shown on the balance sheet for the firm's assets are book values and generally are not what the assets are actually worth.").

<sup>365</sup> See generally *id.*

<sup>366</sup> Bundesgerichtshof [BGH] [Federal Court of Justice] 28, 314 (Ger.).

<sup>367</sup> *Id.*

<sup>368</sup> *Id.*

<sup>369</sup> Article 375 of the KCA provides that: Article 374 shall apply *mutatis mutandis* to a contract whereby a company acquires, within two years from its existence, a certain property which existed prior to its incorporation and [which is] continuously used for purposes of its business, for a value of no less than 5/100 of the capital. Sangbeob [Commercial Act], Act no. 1000, Jan. 20 1962, *amended by* Act. No. 10696, May. 23, 2011, art. 375 (S. Kor.), translated in Korea Legislation Research Institute online database, [http://elaw.klri.re.kr/eng\\_service/main.do](http://elaw.klri.re.kr/eng_service/main.do) (login and search required). Also, Article 434 of the KCA provides that: the resolution set forth in Article 433(1) shall be adopted by the affirmative vote of no less than 2/3 of the [votes] of the shareholders present at the general meeting and of at least 1/3 of the total issued and outstanding shares. Sangbeob [Commercial Act], Act no. 1000, Jan. 20, 1962, *amended by* Act. No. 10696, May 23, 2011, art. 434 (S. Kor.), translated in Korea Legislation Research Institute online database, [http://elaw.klri.re.kr/eng\\_service/main.do](http://elaw.klri.re.kr/eng_service/main.do) (login and search required).

<sup>370</sup> KCA art. 375.

or joint-tenancy ownership, which any creditor can seize by motion,<sup>371</sup> so contributors are often exposed to high risks.

*2. Exception to the Prohibition of Subscription Price Payment by Set-off*

Article 334 of the KCA provides that “a shareholder may not assert a set-off against the company as regards to payment of the subscription price for shares.”<sup>372</sup> Therefore, there is a dispute over whether a claim can undergo the debt-for-equity swap as a set-off for payment. According to the subscription price payment by set-off prohibition theory, payments shall be made in full at the time of incorporation and no payment obligation shall remain after establishment; hence, subscription price payment by set-off cannot be permitted.<sup>373</sup> When a company does not receive payment, every type of set-off, regardless of who makes it or whether it follows an agreement, violates the principle of capital adequacy and is therefore invalid.<sup>374</sup>

On the other hand, exception theory of subscription price payment by set-off prohibition insists that it causes no disadvantage to companies,<sup>375</sup> and there is no reasonable ground to prohibit subscription payment by set-off.<sup>376</sup> It also argues that the purpose of capital adequacy is to protect creditors, whose conversion of claims into investment using set-off would decrease a company’s debts and increase its net assets, thereby helping other creditors get paid.<sup>377</sup>

In Korea, set-offs in agreement with the company or by the company have been affirmed in some cases<sup>378</sup> and denied in others.<sup>379</sup> Since 1998, Korea has generally processed corporate revival by converting insolvent companies’ loans into investments through subscription price payment by set-off.<sup>380</sup>

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<sup>371</sup> If creditors who contribute to new stock intend to preserve their claims, they shall create and register a pledge on the company’s right to claim against contributions to the designated bank and request a return.

<sup>372</sup> KCA art. 334.

<sup>373</sup> *Id.*

<sup>374</sup> See GIBEOM KWON, *KI-EUP-JAE-PYEON-PUB* [Corporate Restructuring Law] 546 (3d ed. 2002) (S.Kor.).

<sup>375</sup> See Juchan Son, *Ju-seok-sang-beob* [Commentary Commercial Law], III 72 JUDICIAL ADMINISTRATION [JUD. ADMIN.] (1999) (S. Kor.).

<sup>376</sup> *Id.*

<sup>377</sup> See Cheolsong Lee, *supra* note 352, at 26.

<sup>378</sup> Supreme Court [S. Ct.], 4292 Minsang 915, Sept. 1, 1960 (S. Kor.).

<sup>379</sup> Supreme Court [S. Ct.], 63Da494, Oct. 22, 1963 (S. Kor.).

<sup>380</sup> Jongho Kim, *Corporate Restructuring Through Spin-Off Reorganization Plan: A Korean Case Study*, 23 PACE INT’L L. REV. 41, 46–47 (2011).

The Supreme Court of Korea has changed its prior position and given notice that in order for a debt-for-equity swap through subscription price payment by set-off to be approved, the registration for capital alteration must be filed with a “verification of payment receipt” with “factual proof of debts,” a debt-for-equity swap agreement between creditors and company, and a verification letter from the Financial Supervisory Service.<sup>381</sup> In reality, loan claims are quite often converted into investments through subscription price payment by set-off; it is likely too late to prohibit or deny this practice.<sup>382</sup>

*B. In-Kind Investment and the Debt-for-Equity Swap*

*1. Dualism of In-Kind Investment*

To make an in-kind investment (payment other than in cash) using loan claims, the claims must *qualify* as an in-kind investment. In-kind investment is dualistic in terms of quality and quantity.

For quantity, it considers the valuation of the contribution and the number of shares to which it is equivalent.<sup>383</sup> Such valuation is based on the liability of stock companies to creditors and shareholders, with the key issue being how valuation should be clarified.<sup>384</sup> The in-kind investment, along with a pecuniary contribution, performs an economic function in corporate financing, but requires clear valuation, as it is the subject of contribution.<sup>385</sup> Furthermore, it may put the investor in economic risk and cause the company to enter bankruptcy.<sup>386</sup>

As to quality, the issue is which objects qualify as investments-in-kind. Submitting loan claims as in-kind investment is not subject to sale, exchange, or satisfaction by law, but is a type of contribution whose objective is to acquire stock.<sup>387</sup> As properties are exchanged for shares in the practice of in-kind in-

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<sup>381</sup> S. Ct. of Korea, *Deung-gi-ye-gyu* [Registration Rule] No. 960.

<sup>382</sup> See Kim, *supra* note 380, at 46–47. Nevertheless, it is necessary to consider the argument that this practice violates the principle of capital adequacy. If a creditor abuses the subscription price payment by set-off to avoid in-kind investment and secures full repayment of claims at face value from the insolvent company, it would cause serious problems. *Id.*

<sup>383</sup> A valuation and an allocation of shares for in-kind investment is similar to ESOP. See William Meade Fletcher, 15 FLETCHER CORP. FORMS § 62:227 (5th ed. 2017).

<sup>384</sup> See DONALD F. KURATKO, ENTREPRENEURSHIP: THEORY, PROCESS, AND PRACTICE 471 (8th ed. 2009).

<sup>385</sup> Petition for Writ of Certiorari, *Aurelius Capital Partners, LP v. The Republic of Argentina*, 584 F.3d 120 (2010) (No. 09-723), at 11–12, 22–23.

<sup>386</sup> See Froot K.A. et al., *Risk Management: Coordinating Corporate Investment and Financing Policies*, 48 J. FIN. 5, 1630-55 (1993).

<sup>387</sup> See HUECK GÖTZ, GESELLSCHAFTSRECHT: EIN STUDIENBUCH 179 (18th ed. 1983). See also FRIEDRICH KÜBLER, GESELLSCHAFTSRECHT 179 (2d ed. 1985); see also KARESTEN SCHMIDT,

vestment and obligations are in opposition, in-kind investment is similar to a bilateral executory contract.<sup>388</sup> Accordingly, as a general rule, “one of the parties in a bilateral contract may refuse performance of his own obligation until the other party tenders performance of his obligation.”<sup>389</sup>

However, if the performance of an obligation of one of the parties to a bilateral contract in which the creditor shall contribute its subscription price other than in cash (i.e., in-kind investment) becomes impossible because of any cause for which neither of the parties is responsible, the obligor (i.e., the stock issuing company) may not be entitled to counter performance.<sup>390</sup>

## 2. *Claims as the Subject of In-Kind Investment*

In the past, the subjects of in-kind investment were generally considered “any type of properties other than cash.”<sup>391</sup> This definition was recently expanded to include anything that can be recorded as an asset on a balance sheet that can be transferred or otherwise considered alienable.<sup>392</sup> Thus, the new definition requires properties to be transferable and specified as assets on balance sheets.

In general, any object that can be considered an asset is transferable because its value can be realized only when it is transferred.<sup>393</sup> Thus, the question becomes what do “substantial assets” on balance sheets include? There is no single definition of assets in the field of accounting, but several approaches may be taken into account.<sup>394</sup> This study briefly examines what types of assets can become the subject of in-kind investment.

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GESELLSCHAFTSRECHT 303, 603 (4th ed. 2002).

<sup>388</sup> An obligation is material in the bilateral executory contract if a breach of contract would result from the failure to satisfy the obligation. See Bob Eisenbach, *Executory Contracts—What Are They and Why Do They Matter in Bankruptcy?*, IN THE (RED) (July 18, 2006), <http://bankruptcy.cool-ey.com/2006/07/articles/business-bankruptcy-issues/executory-contracts-what-are-they-and-why-do-they-matter-in-bankruptcy/>. In U.S. bankruptcy law, “executory contract” assumes a special meaning, being a contract in which continuing obligations exist on both sides of the contract party at the time of the bankruptcy petition—i.e., it requires both the debtor and the counterparty further perform. See, e.g., 11 U.S.C. § 365 (2006).

<sup>389</sup> *Minbeob* [Civil Act], Act no. 471, Feb. 22, 1958, amended by Act. No. 11728, Apr. 5, 2013, art. 536(1) (S. Kor.).

<sup>390</sup> *Id.* art. 537.

<sup>391</sup> See MÜNCHENER KOMMENTAR ZUM AKTIENGESETZ BD. 1 [Munich Commentary on the German Stock Corporation Act] 649 (Bruno Kropff & Johannes Semler eds., 2000) (Ger.).

<sup>392</sup> See Stephen H. Penman, *Accounting for Intangible Assets: There is Also an Income Statement*, CTR. FOR EXCELLENCE SEC. ANALYSIS 1–18 (June 2009).

<sup>393</sup> See Alan C. Shapiro, *Multinational Financial Management*, 613–42 (John Wiley & Sons, 10th ed. 2013).

<sup>394</sup> See ROSS ET AL., *supra* note 12, at 23–24.

(1) *Qualification*: First, for loan claims to become the subject of in-kind investment, their value must be defined. Therefore, the claims for in-kind investment must be due for repayment. The value of claims secured by fixed collateral is determined when the claims are near the time of settlement as stated in the mortgage agreement, the overdue date of the collateral security, or the cancellation or termination of the mortgage contract.<sup>395</sup> When new shares are issued, determination of loan claims requires a resolution by the board of directors and recording on the subscription form for new stock.

Second, the claims must be existing objects with values. The issue here is the meaning of “existing.” The loan claims are considered existing objects with values when they are or can be determined. One must also determine when and how, prior to incorporation, it must exist. The bylaws or the form of subscription for stock require the subject to exist at the time of determination and to be possessed by the contributor. In this respect, a conditional or time-limited in-kind investment is unacceptable. In the debt-for-equity swap, in-kind investment is limited to creditors.<sup>396</sup>

Third, the claims must be valued. As a company allots new stock in exchange for an in-kind investment, there must be a way to conduct an objective valuation of the object. The loan claims can be objectively valued.<sup>397</sup>

Fourth, the subjects of in-kind investment must be transferable as independent entities. The meaning of independence needs a brief explanation. For example, joint tenant properties are not independent by nature, but can be transferred when agreed to by all tenants and all interested persons. Appurtenances or accessories have contribution capacity when they can be separated from the principal and not merely be the elements of other objects. Claims can be transferred as independent entities.<sup>398</sup>

(2) *United States*: Similar to all other legislation based on civil law systems, the U.S. federal and principal state laws do not have a strict and direct supervisory regulation concerning in-kind investment. However, stock companies clearly require capital adequacy and consider in-kind investment as consideration for issuing stocks.<sup>399</sup> Furthermore, consideration must be clearly permitted by an individual state’s constitution or the state’s corporate law to issue new

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<sup>395</sup> See FRANK J. FABOZZI, *FIXED INCOME SECURITIES* 285–87 (2d ed. 2002).

<sup>396</sup> AICPA, *Accounting for Foreign Debt/Equity Swaps Section 12,040.03*, Technical Practice Aids, Practice Bulletin 4, 25,272 (May 1988).

<sup>397</sup> *Id.* § 12,040.04.

<sup>398</sup> 11 U.S.C. § 548 (2012) (providing fraudulent transfers and obligations).

<sup>399</sup> See ROSS ET AL., *supra* note 12, at 273–300 (introducing and explaining various investment criteria).

stock.<sup>400</sup>

Many state laws limit the scope of consideration for issuing stocks to cash, rendered services, and property actually received for the original purpose of company.<sup>401</sup> Some states exclude certain types of consideration and provide a specific list of acceptable consideration.<sup>402</sup> For example, excluded consideration may be promissory notes, future services, and unguaranteed checks, whereas accepted consideration may be the cancellation of obligations or guarantees, other company stocks, overall expenditures, accrued dividends or dividend credits, and franchise rights.

States that do not provide such clarifications also declare through their case law that properties and services can be received as payment of the subscription price if they can be valued and acknowledged.<sup>403</sup> In this situation, the service must already be rendered to the company; hence, future services and services rendered pre-incorporation are disqualified.<sup>404</sup>

The issue is what types of properties can be permitted. The case law leaves this relatively open, but even liberal determinations under state statutory law require that properties must be actually received under contract.<sup>405</sup> Through case law, the following have been permitted as property for consideration.<sup>406</sup>

First, intangible property including patent rights, licenses to use patents, trademarks, and mining and oil leases are acceptable; however, unpatented inventions, secret manufacturing processes, professional knowledge, and goodwill are excluded.<sup>407</sup> Second, tangible assets are included, like mining machinery and auxiliary structures of railroads.<sup>408</sup> Stock in other companies is included only when a company is eligible to own them.<sup>409</sup> Third, claims against the company are also accepted as consideration and may be the subject of in-kind invest-

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<sup>400</sup> See ROBERT S. STEVENS & HARRY G. HENN, *STATUTES, CASES AND MATERIALS ON THE LAW OF CORPORATIONS AND OTHER BUSINESS ENTERPRISE* 247 (1965).

<sup>401</sup> See AB-ALI, *Model Bus. Corp. Act* § 18; *see also* New York Bus. Corp. Law § 504.

<sup>402</sup> See HOWARD LEONER OLECK, *2 MODERN CORPORATION LAW* 4-12 § 607 (1959).

<sup>403</sup> See STEVENS & HENN, *supra* note 400, at 248; *see also* HENRY WINTHROP BALLANTINE, *ON CORPORATION* 791 (1946); WILLIAM MEADE FLETCHER, *11 CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS* 517 § 5185 (1958).

<sup>404</sup> See STEVENS & HENN, *supra* note 400, at 248; *see also* FLETCHER, *supra* note 403, § 5187 at 533.

<sup>405</sup> See OLECK, *supra* note 402, § 606, at 3; *see also* *Thoms v. Sutherland*, 52 F.2d 592, 597 (3d Cir. 1931).

<sup>406</sup> See FLETCHER, *supra* note 403, §§ 5188-94.

<sup>407</sup> See STEVENS & HENN, *supra* note 400, at 248; *see also* FLETCHER, *supra* note 403, § 5189.

<sup>408</sup> See ROSS ET AL., *supra* note 12, at 23.

<sup>409</sup> See FLETCHER, *supra* note 403, § 5192, at 553.



ment. However, creditors' claims must not compete within the creditor group.<sup>410</sup> Fourth, negotiable securities including notes and corporate bonds can also be consideration.

When a company has the right to extend the payment date for a subscriber who has yet to complete payment, the company may establish a claim date in the future to qualify notes from the subscriber or a third person as consideration for the payment.<sup>411</sup> If a company loans monies to its shareholders and, as collateral, accepts notes through a preceding agreement, the law treats this as if no payment has been made.<sup>412</sup> If a note received from a third party is valueless and was already valueless at the time of payment, creditors or beneficiaries may request payments in cash from the subscriber.<sup>413</sup>

Another situation prohibits payments by notes, but generally requires payments in cash or stocks fully paid-in.<sup>414</sup> Certain state codes provide that payment of capital stock is not accepted, regardless of whether shareholders' notes or obligations are guaranteed by securities.<sup>415</sup> This particular provision is interpreted as follows: "According to the provision, notes used to pay for stocks are not considered payments by law and the assignee of the stock or stock subscriber is not exempted from obligations."<sup>416</sup>

However, this provision cannot prohibit companies from receiving notes as consideration for stock, nullify such notes, or exempt note issuers from their obligations to make payments.<sup>417</sup> Even statutes approving such transactions do not allow installment payments as consideration for issuing stocks.<sup>418</sup> However, a subscriber's transferable promissory notes that are guaranteed by proper collateral are thought to constitute property actually received according to the laws of certain states.<sup>419</sup>

Certain state courts have held that a subscriber's payment by notes is a type of consideration different from cash and service and is not prohibited by any law that prohibits stock issuance.<sup>420</sup> However, other courts have held that such provisions are not applicable when stock certificates are transferred to the

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<sup>410</sup> See *id.* § 5197, at 579.

<sup>411</sup> See *id.* § 5194, at 558.

<sup>412</sup> See *Harvey-Watts Co. v. Worcester Umbrella Co.*, 193 Mass. 138 (1906).

<sup>413</sup> See *FLETCHER*, *supra* note 403, § 5194, at 561.

<sup>414</sup> See *Illinois Bus. Corp. Act* § 18.

<sup>415</sup> See *Mississippi Code Ann.* (1942) § 5327; see also *Texas Bus. Corp. Act* (1955) § 2.16.

<sup>416</sup> *German Mercantile Co. v. Wanner*, 25 N.D. 479 (1913).

<sup>417</sup> See *id.*; see also *Hacker v. National Oil Refining Co.*, 73 Pa. St. 93 (1873).

<sup>418</sup> See *Drake Hotel Co. v. Crane*, 240 S.W. 859 (1922).

<sup>419</sup> *Id.*

<sup>420</sup> See *FLETCHER*, *supra* note 403, § 5195, at 566 n.23.

subscriber at the time of payment by notes and are not violated when stock certificates are not yet transferred. Under these circumstances, notes are merely a form of evidence that proves one's intent to pay for stock acquisitions.<sup>421</sup> The law of some other states provides that a subscription price is not fully paid until notes or uncertified checks are paid.<sup>422</sup> Although checks are not considered cash representation, they are treated as valid when made in good faith or under conditional agreements.<sup>423</sup>

(3) *Korea*: The KCA does not have any written provision on the subject of in-kind investment. As noted above, according to academic theories, in-kind investment includes properties other than cash that are accepted as assets on balance sheets and can be converted into cash and convey economic value.<sup>424</sup> As stated above, generally, tangible assets such as real estate, movable assets, and certain intangible assets such as claims, patents, copyrights, computer software, goodwill, special management tactics, customer relations, and others may qualify for in-kind investment.

Some commentators accept goodwill as a contribution,<sup>425</sup> while others argue that the law does not consider goodwill as an object of contribution and that making an in-kind investment using goodwill eventually means contributing certain things, objects, or rights that compose goodwill.<sup>426</sup> Labor and credit contribution are always excluded from in-kind investment.<sup>427</sup>

Scholarly theories are generally positive about making in-kind investment using loan claims against companies at the time of new stock issuance. In other words, the KCA prohibits set-off in subscription price payment, but it often makes exceptions because set-offs are strictly investigated and only accepted when they secure the principal of capital adequacy.<sup>428</sup>

(4) *Discussion*: In the past, in-kind investment at the time of incorporation was limited to promoters, with claims against the company never being consid-

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<sup>421</sup> See *id.* § 5195, at 567–70.

<sup>422</sup> Mich. Stat. Ann. § 22.21; C. L. 1948, § 450.21; Idaho Code, § 30~121; Tenn. Code Ann 1955 § 48~208.

<sup>423</sup> See FLETCHER, *supra* note 403, § 5194, at 561.

<sup>424</sup> See HONGGUINE RHIM, *HOI-SA-BUP* [CORPORATION LAW], 115 (Bupmoonsa 2002) (S. Kor.); See also KIWON CHOI, *SIN-HOI-SA-BUP* [NEW CORPORATION LAW], 156 (10th ed. Parkyongsa 2000) (S. Kor.); See also CHEOLSONG LEE, *HOI-SA-PUP-GANG-EUI* [LECTURE ON CORPORATIONS LAW] 187 (7th ed. Parkyongsa 2002) (S. Kor.).

<sup>425</sup> See CHOI, *supra* note 424, at 293; See also KWON, *supra* note 374, at 292.

<sup>426</sup> See UIDU KANG, *HOI-SA-PUP* [LAW OF CORPORATION], 187 (Hyeongsul Pub. Co. 2002) (S. Kor.).

<sup>427</sup> See RHIM, *supra* note 424, at 42.

<sup>428</sup> See KWON, *supra* note 374, at 292.

ered.<sup>429</sup> However, claims are considered in new stock issuance after incorporation.<sup>430</sup> This idea is considered because accepting claims as a payment for subscription price brings about a reduction in corporate debt.<sup>431</sup> However, it is more reasonable to conclude that debts are accepted at their existing value. Claims against third parties also qualify for in-kind investment; however, transferring claims to the company requires consent from the debtor (third party).<sup>432</sup>

As mentioned above, claims against stock-issuing companies generally qualify as the subject of in-kind investment, so loan obligations can be converted into stock through in-kind investment. In consideration for converting claims into stock, the U.S. Financial Accounting Standards Board (FASB) created the following Financial Accounting Standards (FAS).<sup>433</sup>

When a creditor agrees to convert debts into stock in favor of the debtor (referred to as troubled debt restructuring), the creditor applies the market price of the shares as indicated on the balance sheet.<sup>434</sup> Also, a statement of profit and loss recognizes the difference between the market price of the shares and the carrying amount of decreased debts (the amount of reserve is deducted) as gain on exemption of debts. The creditors also apply the market price as reflected on the balance sheets when deducting the debts.<sup>435</sup> In addition, the statement of profit and loss recognizes the difference between recorded investment (the amount of reserve is not deducted) and the market value of stocks as loss.<sup>436</sup> Such loss is included in net income, except for what is processed by the breakdown of the reserve.<sup>437</sup> Accounting by converting obligations into stock in the

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<sup>429</sup> See 22 U.S.C. § 286e-1h (2012).

<sup>430</sup> See *Public Inv. Ltd. v. Bandeirante Corp.*, 740 F.2d 1222, 1233 (D.C. Cir. 1984).

<sup>431</sup> See *In re Abitibiwater Inc.*, et al., (Trial Order) 2009 WL 8519797 (Bankr. D. Del.) (providing Rights Offering Solicitation Procedures).

<sup>432</sup> See *In re Weiss*, 376 B.R. 867, 873–76 (Bankr., N.D. Ill.); see also *In re Dynavox Inc.*, No. 14-10791-PJW (Bankr. D. Del. 2014).

<sup>433</sup> See Katherine Arline, *GAAP: Standards & Rules for Accountants*, BUS. NEWS DAILY (Apr. 2, 2015), <http://www.businessnewsdaily.com/5486-generally-accepted-accounting-principles-gaap.html#sthash.fB5op3cq.dpuf> (“Accountants apply GAAP through FASB pronouncements referred to as Financial Accounting Standards (FAS). Since its establishment in 1973, the FASB has issued more than 100 FAS pronouncements.”).

<sup>434</sup> FIN. ACCOUNTING STANDARD 15 ¶ 15.

<sup>435</sup> *Id.* 15 ¶ 28.

<sup>436</sup> *Id.* 121 ¶ 24(b).

<sup>437</sup> *Lady Kim T. Inc. v. U.S. Sec’y of Agric.*, 30 Ct. Int’l Trade 1948, 1950 (2006) (“The statute does not define net income, but rather leaves the definition of net income to the discretion of the USDA.”); See also CLYDE P. STICKNEY, ROMAN L. WEIL, KATHERINE SCHIPPER, JENNIFER FRANCIS, *FINANCIAL ACCOUNTING: AN INTRODUCTION TO CONCEPTS, METHODS, AND USES* 145–82, (13th ed. 2009) (explaining the concept of net income). Net income is a commonly used accounting concept for profit. *Id.* In the business arena, net income is an entity’s income minus costs, i.e., goods sold, expenses, and taxes for an accounting period. *Id.* It is computed as the

case of a debtor other than one in a troubled debt restructuring applies the suspension rule that stays the acknowledgement of debt.<sup>438</sup> In other words, when a debtor pays consideration to the creditor to eliminate obligations, the difference between the net carrying amount and reacquisition price is recognized as a gain. The reacquisition price is the market price of the shares issued or the actual value of the debt.<sup>439</sup>

United States' corporate law does not regulate statutory reserve funds<sup>440</sup> or treat the difference between net assets and capital as surplus.<sup>441</sup> However, companies are allowed to convert surplus into capital via a resolution of the board of directors.<sup>442</sup> Thus, accounting by FAS deals with new shares issued by converting obligations by creditors and applies to gains on the exemption of debts on the statement of profits and losses, while the subsequent surplus can be converted into capital.<sup>443</sup>

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residual of all revenues and gains over all expenses and losses for the period. *Id.* Net income can also be obtained by adding a firm's operating income to non-operating income and then subtracting off taxes. See ROSS ET AL., *supra* note 12, at 28.

<sup>438</sup> See Robert F. Reilly, *New Accounting Rules for Troubled Debt Restructurings*, AM. BANKR. INST. J., Oct. 2011, at 54–155 (“Many creditor corporations have had to restructure [their] ‘troubled’ debt instruments. [The] troubled debt restructurings are accomplished either by modifying the debt payment terms or by accepting something of value (e.g., debtor corporation equity securities) in lieu of a cash payment for the debt.”).

<sup>439</sup> See Hennie van Greuning, *International Financial Reporting Standards: A Practical Guide* 60–62 (WBG, 5th ed. 2009) (explaining accounting treatment of acquiring share, financial analysis, and interpretation of equity acquisition).

<sup>440</sup> The word “reserve” has one of three broad meanings in accounting: (1) restrictions of dividend declarations, (2) an offset to an asset, or (3) an estimate of a definite liability of indefinite or uncertain amounts. See CHARLES T. HORNGREN, GARY L. SUNDEM, JOHN A. ELLIOTT, *INTRODUCTION TO FINANCIAL ACCOUNTING* 481 (8th ed. 2002).

<sup>441</sup> Net assets are defined as the total assets minus total liabilities. *Definition of ‘Net Asset Value,’* ECON. TIMES, <http://economictimes.indiatimes.com/definition/net-asset-value> (last visited May 27, 2017). In a corporation, the amount of net assets is reported as shareholder's equity. See *S.E.C. v. Goble*, 682 F.3d 943 (11th Cir. 2012) (“The [SEC] Rule dictates that firms use the regulation's Reserve Formula to calculate the balance they must maintain in the Reserve Account. . . . The specifics of the Reserve Formula are fairly arcane, but its operation is straightforward. . . . Subject to some adjustments, the Rule requires that firms hold an amount equal to the excess of credits over debits in the Reserve Account. . . . If, after the firm makes the reserve computation, it discovers that the Reserve Account balance is higher than the amount required by the Reserve Formula, the firm may make a withdrawal from the Reserve Account.”) (citations omitted).

<sup>442</sup> Under a Wisconsin statute, authorizing payment of dividends only from net profits, a Wisconsin corporation could not convert its existing capital surplus into a reduction of deficit in earned surplus. See WIS. STAT. §182.19 (1943).

<sup>443</sup> See JAN R. WILLIAMS, JOSEPH V. CARCELLO, TERRY L. NEAL, *GAAP GUIDE LEVEL A 2009 RESTATEMENT AND ANALYSIS OF CURRENT FASB STANDARDS*, 43.04–04 (2008).

### 3. *Restrictions on In-Kind Investment as Claims*

In the case of a payment-in-kind, as it is difficult to assess the absolute true value of the object, fraudulent acts such as overstating the object's worth occur frequently, and benefits to investors must mean other shareholders incur some losses.<sup>444</sup> Thus, the KCA imposes strict regulations on in-kind investment.<sup>445</sup> On the other hand, such statutory regulations do not always meet their purpose in the real world. However, despite the ongoing argument on subscription price payment by set-off, until now debt-for-equity swaps have been made through subscription price payment by set-off, but there have not been cases of debt-for-equity swaps by payment-in-kind with claims.<sup>446</sup>

The first reason for shunning payment-in-kind with claims is its complex and strict statutory procedure. The second reason encompasses the time and expense involved. A third reason can be attributed to the fact that when the subscription payment is made in-kind, evaluation of claims are completed according to a more conservative standard, and therefore the amount of real claims do not exceed a nominal value.<sup>447</sup> In this situation, creditors are compelled to reduce the amount of their claims to reach a settlement.<sup>448</sup> However, as the means of payment-in-kind is considered least likely to cause damage to existing shareholders and other creditors, making a payment-in-kind seems reasonable in a debt-for-equity swap. The following evaluations must be made when the subscription price payment-in-kind is made with claims.

(1) *Evaluation of Claims for in-kind investment*: When a company is incorporated, any payment-in-kind should appear in the certificate of incorporation.<sup>449</sup> In addition, the KCA requires adherence to a series of procedures such as including the statement of price on the subscription form, obtaining an ap-

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<sup>444</sup> See RICHARD A. BREALEY, STEWART C. MYERS, ALAN J. MARCUS, *FUNDAMENTALS OF CORPORATE FINANCE* 394 (4th ed. Irwin 2004).

<sup>445</sup> Issues related with avoiding in-kind investments are being discussed in Germany. Concealed in-kind investment refers to all kinds of methods not in compliance with legal provisions, but that bring about the same result as an in-kind investment (i.e., payment via assets other than cash). See BGHZ 28, 314. The representation of this method is as follows: First, a party wishes to make an in-kind investment in lieu of a cash payment; After the company is incorporated, the party transfers the object for in-kind investment to the company; the company makes the payment in cash back to the party; and the result is the same result as an in-kind investment. *Id.*

<sup>446</sup> See Jacques Henrot, Joanna Gumpelson and Samuel Giorgi, De Pardieu Brocas Maffei, *Debt-Equity Swaps in France: Recent Developments*, (Thomson Reuters Practical Law 2012) (Mar. 1, 2012) (stating case study of Akerys Restructuring).

<sup>447</sup> Yuta Seki, *The Use of Debt-Equity Swaps by Japanese Companies*, 5(2) CAPITAL RESEARCH J., Summer 2002, at 2–16.

<sup>448</sup> *Id.*

<sup>449</sup> KCA art. 290.(2).

praisal by either inspectors or certified appraisers, and obtaining court approval.<sup>450</sup> These are all based on the premise that an appropriate evaluation method exists. However, as the KCA lacks any provisions regarding the evaluation method, the only persuasive authorities are case law and generally accepted accounting conventions.<sup>451</sup> As for the case law, concrete references are scant.<sup>452</sup>

Claims can be evaluated as follows: the amount of the claims is the amount of the object and the claim's interest can be included in the evaluation if it is both rational and appropriate in light of usury law.<sup>453</sup> However, expenses incurred in making debt-for-equity swaps for claims cannot be included in the amount of the claims.<sup>454</sup>

On the other hand, when the company has insufficient financial resources, lacks resources for the investor's payment-in-kind, or lacks current assets, the estimated value of the claims must be reduced.<sup>455</sup> Moreover, it is very difficult to make an accurate evaluation of claims in the case of bad loans.<sup>456</sup>

Depending on the degree of insolvency, the actual value of the claims can be zero. This case causes difficulties because there is no objective standard for the valuation of claims. Possible alternate means of valuation are: (i) reference to the allowance for bad loans compiled by the financial institutions, or (ii) assessment of the possible investment money of the concerned company.<sup>457</sup> The second method is to set up a standard using a scale of the recoverable amounts available when the debenture becomes liquidated in the bond market.<sup>458</sup>

(2) *Overvaluation of Claims and Responsibility of the In-Kind Investment:*

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<sup>450</sup> KCA arts. 295–99.

<sup>451</sup> See 26 U.S.C. § 409(a) (2012). The U.S. Tax Code provides valuation approaches including the asset approach, the market approach, and the income approach. *Id.*

<sup>452</sup> See GAUGHAN, *supra* note 17, at 11–14.

<sup>453</sup> Various fees and charges, regardless of title, are included in loan interest rates for purposes of NY usury law. See *In re Rosner*, 48 B.R. 538, 547–51 (Bankr. E.D.N.Y. 1985). See also *Funding Group, Inc. v. Water Chef, Inc.*, 852 N.Y.S.2d 736 (Sup. Ct. 2008); *Weiss v. Screen Arts Corp.*, 2009 N.Y. Misc. Lexis 4705 (Sup. Ct. 2009); *Lugli v. Johnston*, 912 N.Y.S.2d 108 (App. Div. 2010).

<sup>454</sup> See *In re Rosner*, 48 B.R. 547–51.

<sup>455</sup> See Ann Cullen, *Distressed Private Equity: Spinning Hay into Gold*, HARV. BUS. SCH.: WORKING KNOWLEDGE, Feb. 16, 2004, <http://hbswk.hbs.edu/archive/3914.html>.

<sup>456</sup> In many bankruptcy reorganization cases, a big controversy arises as to whether there has been a proper valuation of the nonperforming loan. See Jongho Kim, *Bankruptcy*, *supra* note 327, at 122–31. This is because when stock is issued via the debt-for-equity swap under a plan of reorganization and the reorganized corporation fails to execute the plan, shareholders who were prior creditors have difficulty getting their cash returned in the stock market. *Id.*

<sup>457</sup> At this time, the recovery rate of claims for such a company should be considered.

<sup>458</sup> Debentures are issued on the basis of general credit of the corporation. See CARL S. WARREN, JAMES M. REEVE & PHILIP E. FEES, *FINANCIAL AND MANAGERIAL ACCOUNTING* 505 (6th ed. 1999).

The two approaches to protecting investors are providing clear evaluation methods and making appropriate evaluations of the objects for the payment-in-kind. In other words, the first is the disclosure philosophy that underlies the regulation of stock issuance, in which the pertinent information on the shares must be completely disclosed so investors can evaluate the stock.<sup>459</sup> The second is the regulatory philosophy that holds that delegating judgment about a stock's value to investors is insufficient, so a government agency or other organization should regulate the stock to protect investors.<sup>460</sup> The British corporate law of 1968 and the U.S. Securities Act of 1933 belong to the first approach, while Korean corporate law (Part V of the Commercial Act) and those of Japan and Germany belong to the second.<sup>461</sup>

The preciseness of the evaluation method for the claims in payment-in-kind excludes an arbitrary evaluation and is the means of yielding an appropriate estimated value. At the same time, the directors have a duty in the evaluation.<sup>462</sup> Furthermore, the issue of inspector or appraiser responsibility also arises in cases of overvaluation.<sup>463</sup> If new stocks are issued based on overvalued claims, the issuance of new shares can be nullified and the company may be obliged to return the difference to subscribers.<sup>464</sup>

(3) *Responsibility of Investors Concerned with In-Kind Investment for Claims*: A person who took over the stock at a notably unfair issue price by working in collusion with the directors or auditors shall be liable to pay back any amount equivalent to the difference from the fair issue price and can also be held liable for damages to the company or shareholders.<sup>465</sup> This responsibility and the payment responsibility of the underwriters are related to their joint and several liabilities. Although it may be a general principle to hold directors to account for their company, the derivative action by minority shareholders is also a useful means, as many cases involve favoritism.<sup>466</sup> In the case of auditors, the responsibility cannot be avoided if there is an overstatement of the payment-in-

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<sup>459</sup> NICHOLAS L. GEORGAKOPOULOS, *PRINCIPLES AND METHODS OF LAW AND ECONOMICS* 154–74 (2005) (explaining confronting uncertainty, focusing on the basic probability theory).

<sup>460</sup> *Id.* at 213–14.

<sup>461</sup> The core purpose of disclosure is to promote transparency of the market environment. See Mary Jo White, Chair, SEC, *The Path Forward on Disclosure*, Remarks at the National Association of Corporate Directors Leadership Conference (Oct. 15, 2013), <http://www.sec.gov/News/Speech/Detail/Speech/1370539878806#.U7ladhbs7wI>.

<sup>462</sup> See Ernst & Young, *Financial reporting developments - A comprehensive guide, Issuer's accounting for debt and equity financings* 27–29 (Sep. 2016).

<sup>463</sup> *Id.*

<sup>464</sup> See Min, *supra* note 6.

<sup>465</sup> KCA art. 424–2, cl. 3.

<sup>466</sup> *Id.* cl. 2.

kind.<sup>467</sup>

Inspectors or appraisers inspect not only the accuracy of the computation of the payment-in-kind, but also the objectivity of evaluation and the possibility of illegality in the investment business.<sup>468</sup> Where the inspector has failed to perform his duties, either willfully or by gross negligence, he shall be liable for damages to the company or to third persons.<sup>469</sup> In addition, where the inspector has concealed facts or made unsatisfactory reports to the promoters, the general meeting of shareholders, or the court about the execution of the payment-in-kind, underwriting, or payment of the investment or stocks, he may be criminally liable for endangering the company assets.<sup>470</sup>

(4) *Underestimation of Claims for In-Kind Investment*: In view of the fact that the payment-in-kind is a particular of abnormal incorporation, the argument on the prevention of overvaluation is an active one, but little is being discussed regarding the underestimation of the payment-in-kind.<sup>471</sup> In Korea there is an argument focused on tax law, stipulating that an underestimation of the payment-in-kind will cause tax evasion.<sup>472</sup> Also, from the corporate law standpoint, underestimation at the end of the business year will be disadvantageous for dividends from the appraisal profit. Moreover, there is a possibility of creating a kind of secret, illegitimate reserve fund.<sup>473</sup>

However, there is an argument that such issues are not necessarily illegitimate, because they are not detrimental to the interests of shareholders and creditors but only to the investor who will consequently suffer for an underestimation of the payment-in-kind.<sup>474</sup> Yet even though the payment-in-kind for claims is likely to result in an evasion problem from the tax law perspective, it seems difficult to view it as the reason to take preventive measures. It seems that there is no reason to regard the underestimation of claims as illegitimate, as it is not detrimental to shareholders or other creditors, even though the investing

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<sup>467</sup> *Mishkin v. Peat, Marwick, Mitchell & Co.*, 744 F. Supp. 531, 538 (S.D.N.Y. 1990).

<sup>468</sup> KCA art. 325.

<sup>469</sup> *Id.*

<sup>470</sup> *Id.* art. 625, cl. 1(1).

<sup>471</sup> On this issue, in Germany there are positive and negative doctrines opposing each other. See KURT BALLERSTEDT, *KAPITAL, GEWINN UND AUSSCHÜTTUNG BEI KAPITALGESELLSCHAFTEN* [CAPITAL, PROFITS, AND DIVIDE FOR CORPORATIONS] 73 (1949) (Ger.); see also HOFFMANN BECKING, *AKTIENGESELLSCHAFT IN: MÜNCHENER HANDBUCH DES GESELLSCHAFTSRECHTS* [STOCK CORPORATION IN MUNICH HANDBOOK OF COMPANY LAW] 20 (2015) (Ger.).

<sup>472</sup> Generally, this kind of corporate strategy is treated as a crime under the statute. See Gary Becker, *Crime and Punishment: An Economic Approach*, 76 J. POL. ECON. 169, 169–217 (1968).

<sup>473</sup> T.A. LEE & ROBERT H. PARKER, *EVOLUTION OF CORPORATE FINANCIAL REPORTING* 279 (eds., 2015) (introducing use of secret reserve fund for many companies).

<sup>474</sup> See KWON, *supra* note 374, at 29.



creditors sustain a loss.

(5) *Proper Evaluation Methods for Loan Obligations*: The biggest issue when a debt-for-equity swap is made by means of a payment-in-kind is how to evaluate the underlying claim (i.e., the major question is how to make a correct allotment of outstanding shares). The company will likely only be concerned with the amount of debt handled. Generally in corporate accounting, as debt is recognized at its face amount, it cannot be subject to evaluation in principle.<sup>475</sup> As the debt is retired and the company's balance sheet is converted to reflect its face amount, the execution of the payment-in-kind converts debt to equity, which is consistent with the increment of the capital as the face amount.<sup>476</sup>

The estimated value of the claims is affected by whether there is a surety or mortgage, but as the payment-in-kind is executed, it may be unreasonable for the increment of capital to be influenced by such factors. However, use of the face amount only applies to the company. Creditors should use the actual amount (estimated value) that takes claim recoverability into consideration. Their standpoints differ because the company recognizes debt from a going-concern value,<sup>477</sup> whereas the creditors evaluate their claims on the basis of the liquidation value, because they assume the company will go bankrupt unless the debt is restructured.<sup>478</sup>

However, no matter which theory is applied, little difference will result as the reduced amount of company debt has to be the same.<sup>479</sup> This is because the equilibrium of the final amount of net assets is made through the nominal reduction of capital, even when the increment in capital makes a difference.<sup>480</sup> In the end, the biggest difference lies in the fact that using the face amount saves time and expense.<sup>481</sup>

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<sup>475</sup> *But see* *Cities Service Co. v. United States*, 522 F.2d 1281, 1286 (2d Cir. 1974) ("Debt discount typically results from the sale by an issuer of its debt obligation on the market at an issue price below the face amount of the obligation. The difference is referred to as the discount.")

<sup>476</sup> *See* Jun Harizuka, TOKYO CHIHŌ SAIBANSHO MINJIBU NI OKERU GENBUTUSHUSSHITŌ KENSAYAKUSEN'NIN JIKEN NO [THE SITUATION OF INVESTIGATOR APPOINTMENT CASE OF IN-KIND INVESTMENT IN TOKYO DISTRICT COURT COMMERCIAL BENCH] 4 (2001) (Jap.); *see also* Hiteki, *supra* note 60, at 32. In Japan, the Tokyo District Court Commercial Division Bench officially adopted the face value theory in a debt-for-equity swap. *Id.*

<sup>477</sup> Kim, *supra* note 327, at 121–27.

<sup>478</sup> *Id.* at 121–26.

<sup>479</sup> *See* Jongho Kim, *Bankruptcy Law Dilemma: Appraisal of Corporate Value and Its Distribution in Corporate Reorganization Proceedings*, 29 NW. J. INT'L L. & BUS. 119, 128, 133, 150 (2009) (introducing corporate insolvency-liquidation or rehabilitation).

<sup>480</sup> *Id.* at 156, 160.

<sup>481</sup> *Id.* at 119, 124–25, 133–35, 138–141.

#### 4. *Number of Shares to be Issued Through the In-Kind Investment*

In executing debt-for-equity swaps, the number of shares to be distributed to creditors becomes the issue. From the creditors' standpoint, they will want to have as many shares as possible, while the company will expect the number of shares issued not to damage the existing shareholders.<sup>482</sup> The number of shares to be issued can be said to be the estimated value of the claims offered for the payment-in-kind divided by the actual amount per share.<sup>483</sup> The above mentioned estimated value of the concerned claims is reflected in the mortgage (or includes the amount of guarantee, if applicable) while the actual amount per share refers to the anticipated and added amount resulting from the execution of the payment-in-kind.<sup>484</sup>

#### 5. *Tax Treatment*

When a domestic corporation makes a debt-for-equity swap for obligations pursuant to a workout agreement,<sup>485</sup> the difference between the amount of the issue price of the concerned shares and the market price is summed up as the benefit realized from the obligation exemption according to the accounting standard.<sup>486</sup> This amount is regarded as the premium amount of the stock issuance according to Article 17 Clause 1(1) of the Corporate Income Tax Act or Article 20(3) of the same Act.<sup>487</sup> It is considered a difference in the discounted stock issuance, not being included as either profit or loss in that year's accounting period.<sup>488</sup>

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<sup>482</sup> But it is practically impossible. A U.S. "trial court recognized, 'payments-in-kind' [...] represent the issuance of additional paper securities to existing debt or equity holders." *Westfed Holdings, Inc. v. United States* 407 F.3d 1352, 1368 (Fed. Cir. 2005).

<sup>483</sup> See generally Jongho Kim, *Bankruptcy*, supra note 327, at 177–78.

<sup>484</sup> See *In re Dow Corning Corp.*, 211 B.R. 545, 557–60 (E.D. MI 1997).

<sup>485</sup> See GAUGHAN, supra note 17 and accompanying text.

<sup>486</sup> "Accounting is generally considered to be the process of keeping track of a business' finances by keeping track of" all of its business transactions. Chad Brooks, *What Are Accounting Standards?* BUSINESS NEWS DAILY, (Jun. 11, 2012), <http://www.businessnewsdaily.com/2664-accounting-standards.html> (last visited July 12, 2016). Accounting "standards ensure that financial statements from all businesses are reported fairly and accurately. They cover things such as the measurement of economic activity, when those measurements are to be made and recorded, and the disclosures surrounding required activity under the law." *Id.*

<sup>487</sup> CORPORATE TAX ACT arts. 17(1), 20(3) (2001) (S. Kor.).

<sup>488</sup> See Korean National Tax Service Rule, Yekyu [Regulation], Pubin [Corporate entity] 46012–1608, (Jul. 20, 2000) (S. Kor.).

### 6. *Performance of In-Kind Investment*

(1) *Resolution of the Board of Directors*: In case of issuance of new shares, if payment-in-kind is not mentioned in the certificate of incorporation, it may be accepted via a resolution of the board of directors.<sup>489</sup> However, it is different if the KCA provides otherwise or if the certificate of incorporation requires a decision to be made at the shareholders' meeting.<sup>490</sup> The board of directors shall decide the names of the person(s) making the payment-in-kind for claims, the kinds of stock to be granted, and the number of shares in accordance with the amount of debt.<sup>491</sup>

Unlike establishing a new company, the issuance of new shares can result in various issues because the items are not stated in the certificate of incorporation but left up to the resolution of the board of directors. For instance, if a payment-in-kind is made with only a board of directors' resolution,<sup>492</sup> it violates the preemptive rights of the original shareholder(s).<sup>493</sup> Moreover, it may be a significant violation of shareholder rights because the board of directors can change corporate governance at any time through the form of payment-in-kind.<sup>494</sup> Therefore, a payment-in-kind calling for changes in shareholders' preemptive rights must go through a special resolution at the shareholders' general meeting (provisions of the certificate of incorporation can substitute for this requirement).<sup>495</sup> However, if a company has provisions regarding debt-for-equity swaps as part of its corporate reorganization procedure, the debt-for-equity swap can be made accordingly.

(2) *Performance of Payment*: A person who is to make a contribution-in-kind shall deliver the pertinent property, without delay, on the date fixed for the payment of the subscription price, and if registration, recording, or the creation or transfer of a right is required, he shall fully prepare the documents thereon and deliver them to the company.<sup>496</sup> In other words, if the object of the pay-

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<sup>489</sup> KCA art. 416 § 1.

<sup>490</sup> KCA art. 416.

<sup>491</sup> KCA art. 416 § 4.

<sup>492</sup> If the bylaws or certificate of incorporation require issuance of new stock to be done at a general meeting of shareholders, it shall be decided by a shareholder meeting. See KCA art. 416.

<sup>493</sup> See *supra* notes 148, 305–06, 326, 339 and accompanying text.

<sup>494</sup> Here, corporate governance means a typical corporation's management structure. See U.S. v. Brooks, No. 06-CR-550(S-1) (JS), 2010 WL 291769, at 4 (E.D.N.Y. Jan. 11, 2010). Any expert may testify general concepts of corporate governance, if only and necessary, court permit to do that in the trial. *Id.*

<sup>495</sup> See Keonsik Kim, *Hyeon-mul-chil-ja-wa-sin-ju-in-su-kwon* [In-kind Investment and Preemptive Right], 31 SEOUL UNIV. L.J. 205 (1990); see also CHEOLSONG LEE [Lecture], *supra* note 424, at 651; Clarendon Grp., Ltd. v. Smith Labs., Inc., 741 F.Supp. 1449, 1453 (S.D. Cal. 1990).

<sup>496</sup> KCA arts. 425, 305 § 3, 295 § 2.

ment-in-kind is personal property, a transfer of possession shall be made. If the object is real property, the deed shall be delivered and cooperation shall be given as to its registration and filing, or if creation of other rights is needed, the required documents must be prepared and delivered.<sup>497</sup>

When the payment-in-kind is made for claims, a written confirmation of the existence of the claims, the agreement on the debt-for-equity swap between creditors and company, and its corresponding certified confirmation by the director of the Financial Supervisory Service must be prepared.<sup>498</sup> If the contribution-in-kind is not performed on the fixed payment date by the underwriter of the new shares, the right shall be forfeited.<sup>499</sup> Should there be a loss to the company in the end, compensation for that loss on the payment-in-kind can be made.<sup>500</sup> The forfeiture shall not affect any claim for damages against the person who has subscribed for new shares.

(3) *Investigation by Inspectors or Appraisers*: In case of a corporation, as the shareholders have only limited liability, there is risk in stock issuance at discounted prices. As a result, the basis of capital is at risk and there is potential for concerned persons and company creditors to incur loss if the object of the payment-in-kind is overvalued.<sup>501</sup> Therefore, a strict investigation is required in cases of payment-in-kind.<sup>502</sup> In other words, if a person is making the payment-in-kind, the court should appoint a commissioner for the investigation.<sup>503</sup> However, an appraisal by a certified appraiser can replace the commissioner's investigation.<sup>504</sup> Such investigative procedure is entirely the same in the case of claims.<sup>505</sup>

In the United States, unlike under the KCA, there is no system for investigation.<sup>506</sup> It seems as though evaluation of a payment-in-kind is technically too

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<sup>497</sup> KCA art. 295.

<sup>498</sup> Don Kirk, *Equity Swap Seen for Hyundai*, NEW YORK TIMES: BUSINESS DAY (Mar. 28, 2001), <http://www.nytimes.com/2001/03/28/business/equity-swap-seen-for-hyundai.html> (last visited July 15, 2016).

<sup>499</sup> KCA art. 423 ¶ 2.

<sup>500</sup> KCA art. 423 ¶ 3.

<sup>501</sup> See Transcript of Expert Testimony, *Glendale Federal Bank, v. United States*, 1990 WL 10507945 (Fed. Cl. 1990) (No. 90 CV 772).

<sup>502</sup> KCA art. 422 § 1.

<sup>503</sup> *Id.*

<sup>504</sup> *Id.*

<sup>505</sup> KCA art. 422 ¶ 1.

<sup>506</sup> In some exceptional cases, bonds were issued at a discount to get income tax benefits. See *Am. Smelting & Ref. Co. v. United States*, 130 F.2d 883 (3d Cir. 1942). In another case, as to transformation of capital structure of the corporation, the "corporation was entitled to bond discount deduction in the bonds-for-stock exchange as is permitted in bonds-for-cash exchange." *Gulf, M. & O. R. Co. v. United States*, 339 F.Supp. 489 (S.D. Ala. 1972).

difficult, and making an objective decision on the amount is not easy. Thus, according to the true value rule that requires the object to be evaluated in its true amount, the judgment of the directors and underwriters regarding the evaluation is respected.<sup>507</sup> When overvaluation results from accounting fraud or willful false testimony, those making the overvaluation can be held liable by good faith creditors.<sup>508</sup>

### 7. *Remedy for Nonperformance of In-kind Investment for Obligations*

(1) *Compulsory Execution*: If the creditors voluntarily fail to perform the payment-in-kind, the performance can be forced by means of statutory compulsory execution, and compensation for delay can be requested.<sup>509</sup> However, when the object is claimed, it can also be handled by a set-off.<sup>510</sup>

In general, compensation for damages arising from the nonperformance of an obligation shall be limited to ordinary damages.<sup>511</sup> In addition, the obligor is responsible for damages that have arisen through special circumstances only if he has foreseen, or could have foreseen, such circumstances.<sup>512</sup> However, these general rules shall not be applied as a remedy for nonperformance of a contribution-in-kind.<sup>513</sup>

There is no provision in the KCA regarding when incomplete performance or impossibility of performance ensues due to defects in the rights attached to the object or the object itself.<sup>514</sup> For such cases, provisions on the risk of loss,<sup>515</sup> liability for security,<sup>516</sup> and warranty exist in the Korean Civil Code (KCC), which shall be applied to cases of payment-in-kind for claims.<sup>517</sup> In other words, the provisions in the KCC shall be applied *mutatis mutandis* if the legal charac-

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<sup>507</sup> *True-Value Rule and Legal Definition*, USLEGAL, <https://definitions.uslegal.com/t/true-value-rule/> (last visited May 27, 2017).

<sup>508</sup> See HARRY G. HENN & JOHN R. ALEXANDER, *LAW OF CORPORATIONS* 420–21 (West Group, 3rd ed. 1983).

<sup>509</sup> Minbeob [Civil Act], Act No. 8720, Dec. 21, 2007, art. 389 (S. Kor.).

<sup>510</sup> *Id.*

<sup>511</sup> Minbeob [Civil Act], art. 393, cl. 1; see Mindy Chen-Wishart, Alexander Loke, & Burton Ong, *Studies in the Contract Laws of Asia: Remedies for Breach of Contract*, OXFORD U. PRESS, Mar. 28, 2016, at 173–74 (showing examples of ordinary damages based upon market price).

<sup>512</sup> Minbeob [Civil Act], art. 393, cl. 2.

<sup>513</sup> *Id.*

<sup>514</sup> *Id.*

<sup>515</sup> Minbeob [Civil Act], art. 537.

<sup>516</sup> Minbeob [Civil Act], arts. 570, 580.

<sup>517</sup> *Id.*

teristics of the payment-in-kind are regarded as forming an executory contract, because they have not yet been performed.<sup>518</sup>

(2) *Termination of the Contract*: In the case of payments-in-kind for claims, can contract termination be made according to the general principles of breach of contract by nonperformance? In other words, the issue is whether the undertaking of the shares by means of the payment-in-kind has the characteristics of an executory contract, the termination of which affects a third party.<sup>519</sup> Giving no heed to the sequence of the incorporation of company, the termination of the contract should be interpreted as being disapproved.

(3) *Procedures for Forfeiture of Subscriber Rights*: If the subscription price payment is not paid, the subscriber's new stocks forfeit their status according to forfeiture of rights procedure.<sup>520</sup> However, an issue arises when performance of the payment-in-kind is delayed, similar to delay in the cash payment of subscription price.<sup>521</sup> However, even when the forfeiture of rights is acknowledged in a payment-in-kind, the forfeiture procedure should not be applied because the performance cannot be replaced.<sup>522</sup> This is especially true for payment-in-kind for claims via corporate reorganization plans.

### *C. Subscription Price Payment by Set-off and Debt-for-Equity Swap*

As to contribution in claims, there is an issue regarding whether a banking institution's loans require consideration through means of a subscription price payment by set-off other than a payment-in-kind.

As several South American countries and numerous companies experienced serious financial crisis and insolvency in the mid-1980s,<sup>523</sup> the U.S. banks that made loans to those companies executed debt-for-equity swaps on nonperforming loans, whereby obligations on loans were converted into shares.<sup>524</sup> Through these transactions, companies were resurrected while creditors' rights were protected.

Since 1997, in Korea and China, there have been many debt-for-equity

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<sup>518</sup> *Id.*

<sup>519</sup> See Eisenbach, *supra* note 388 and accompanying text.

<sup>520</sup> Sangbeob [Commercial Act], Act No. 10696, May 23, 2011, art. 307 (S. Kor.), translated in Korea Legislation Research Institute online database, [http://elaw.klri.re.kr/eng\\_service/main.do](http://elaw.klri.re.kr/eng_service/main.do) (login and search required).

<sup>521</sup> See USA INT'L BUS. PUBLICATIONS, FINLAND COMPANY LAWS AND REGULATIONS HANDBOOK, STRATEGIC INFORMATION AND BASIC LAW 115, 116 (2012).

<sup>522</sup> See Brief for Petitioners at 124–25, *Wolf v. Weinstein*, 372 U.S. 633 (1963), 1962 WL 115462.

<sup>523</sup> See *supra* Section I.A.

<sup>524</sup> See arguments *supra* Section II.A.

swaps by banks that made loans to insolvent companies.<sup>525</sup> Without exception, the approved reorganization plans of those companies had provisions for debt-for-equity swaps.<sup>526</sup> However, even though making the direct debt-for-equity swap of such loan obligations to the debtor corporation requires only a simple structure, an issue arises regarding whether a set-off can be made between the payment of subscription prices and creditor claims against the company.<sup>527</sup>

With regard to the above issue, the Korean Supreme Court rendered an opinion that the method of subscription price payment by means of a set-off is not acknowledged as a subscription price payment.<sup>528</sup> This is because the Supreme Court made an authoritative interpretation based on Article 334 of the KCA, which states that a shareholder may not assert a set-off against the company when it consists of a subscription price payment for shares.<sup>529</sup> The Supreme Court's interpretation has been considered natural, as issues have yet to be raised on this matter in practice. However, the banks' desire for debt-for-equity swaps after the Asian currency crisis of 1997 shed new light on Article 334, which, depending on its interpretation, can have a huge impact on the revival of an insolvent company following the execution of a plan for reorganization.

Article 334 of the KCA provides that a shareholder may not assert a set-off against the company in regard to payment of the subscription price for shares.<sup>530</sup> If we interpret this from a grammatical perspective, it means that shareholders cannot make a set-off for repayment of the subscription price using their claims against companies, but it can also be interpreted as allowing the company to assert a set-off against shareholders or to make a set-off under the agreement between the company and the creditors who subscribed to the

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<sup>525</sup> Yuan Yang, *China explores debt-for-equity swaps to defeat bad debt pile-up*, FIN. TIMES (Mar. 16, 2016), <https://www.ft.com/content/c6e7ccc2-eb44-11e5-bb79-2303682345c8>; David Brown, *Making the case for Chinese debt equity swaps*, FIN. TIMES, (May 25, 2016), <https://www.ft.com/content/79f5c306-1e6b-11e6-b286-cddde55ca122>.

<sup>526</sup> *Id.*

<sup>527</sup> LES R. DLABAY, JAMES L. BURROW, BRAD KLEINDL, *INTRO TO BUSINESS* 469 (Mason, Ohio: South-Western Cengage Learning, 7th ed. 2009). A set-off clause can refer to a settlement of mutual debt between a creditor and a debtor through offsetting transaction claims. *Id.* This allows creditors to collect a greater amount than they usually could under bankruptcy proceedings. *Id.* The Truth in Lending Act to protect consumers prohibits set-off clauses from applying to some transactions. See Pub. L. 90-321, ch. 41 (codified at 15 U.S.C. § 1601 (2012)).

<sup>528</sup> Korea Minister of Court Administration, *Inquiry & Answer, Deunggi* [Registration] 3402–559, (Jun. 23, 1998).

<sup>529</sup> This process is completely different than the process in the United States.

<sup>530</sup> IBP, INC., *KOREA SOUTH COMPANY LAWS AND REGULATIONS HANDBOOK VOL.1 - STRATEGIC INFORMATION AND BASIC LAW* 92 (2015).

shares.<sup>531</sup> In the view of this author, the wording of the law is insufficient to prohibit a set-off against a company or the approval of a set-off agreement based on Article 334 of the KCA.

*1. Rationale for Prohibiting Subscription Price Payment by Set-off*

There are three reasons for prohibiting set-offs against subscription price payment. First, when the true value of the creditors' claims does not exceed the nominal amount of the claims and the repayment and the set-off for the subscription price payment is made with the nominal amount, it will give rise to the exemption of payment obligations by the difference of the true value and the nominal value.<sup>532</sup>

Second, it causes confusion between organizational obligations and transactional obligations. If the subscriber's payment by set-off is allowed, the risk involved in the claims according to transactional regulations can be exempted by using the obligations according to organizational regulations (and vice versa).<sup>533</sup> In other words, a subscriber's payment obligation is regulated by organizational law while claims by set-off fall under transactional law. Therefore, the nature and degree of risk borne by the company and subscribers are different.<sup>534</sup> Accordingly, if subscription price payment by set-off is permitted, a complex problem arises in sharing the risk equally through the set-off.<sup>535</sup> For example, when companies fall into default on debt payments, creditors as subscribers take the risk of the partial irrecoverable debt or the entire amount of claims equally, but the subscribers assume the obligations by organizational law to completely perform the payment of subscription obligations.<sup>536</sup>

Third, the purpose may be seen as an attempt to avoid in-kind investment, which demands a strict procedure. However, such strict procedure can be omitted if the claims are employed by means of a subscription price payment by set-off.<sup>537</sup> In other words, the set-off can be used as a means to avoid strict regulation of the in-kind investment. Moreover, if claims against a defaulted company were made by in-kind investment, the true value of the claims shall be determined with the valuation taking into consideration the repayment ability of the

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<sup>531</sup> See *Sawyer v. Hoag*, 84 U.S. 610, 622 (1873).

<sup>532</sup> *Id.*

<sup>533</sup> *Kiskadden v. Steinle*, 203 F. 375, 379–80 (6th Cir. 1913).

<sup>534</sup> *Id.*

<sup>535</sup> See *Sawyer*, 84 U.S. at 622–23.

<sup>536</sup> *Kiskadden*, 203 F. at 379–80.

<sup>537</sup> See DAVID MINARS, CORPORATIONS STEP-BY-STEP 32–42 (2d ed. 2003).



company.<sup>538</sup> Thus, particularly for a company lacking the ability to repay, some reduction in the valuation will be made.<sup>539</sup> As subscribers, the creditors may regard this reduction in valuation as a loss. Therefore, rather than an in-kind investment, subscription price payment by set-off is preferred, or it can even be used as a means to avoid an in-kind investment.

In addition, the set-off method is used when the person who wants to make an in-kind investment transfers the object of the in-kind investment to the company and makes a cash set-off against the proceeds and contribution obligations.<sup>540</sup> In this instance, the amount of proceeds and the payment in cash can be settled by contract.<sup>541</sup>

## 2. Possibility of Subscription Price Payment by Set-off in Korea

(1) *Theory*: Academic doctrine in Korea interprets the prohibition of subscription price by set-off as securing the principle of capital adequacy.<sup>542</sup> This is based on the concern that there may be a capital adequacy risk if shareholders assert the set-off against the company. Therefore, it should be prohibited. Still, there are arguments regarding whether set-offs by the company or by an agreement with the company can be approved.<sup>543</sup>

One argument is that the company can use its claims to set-off its debts to creditors when it has the right to demand payment of the subscription price.<sup>544</sup> As an example, when shareholders enter into personal bankruptcy proceedings, the company can make a set-off outside of the bankruptcy proceedings as a bankruptcy creditor.<sup>545</sup> On the contrary, when the company goes bankrupt, the shareholders cannot make set-offs in accordance with Article 334 of the KCA.<sup>546</sup>

In addition, when a company does not impose a set-off, Article 334 of the

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<sup>538</sup> See *id.* at 87 (showing the use of debt in the capital structure).

<sup>539</sup> See Decision of Commission in Investigation of Tank Car Allowance System, 7 I.C.C.2d 645, 1991 WL 149964 (June 24, 1991) (discussing on how to decide true value).

<sup>540</sup> See, e.g., Stock Purchase Agreement, U.S. Retirement Partners, Inc., et al, v. Clearcreek Financial Group, Inc., et al., 2009 WL 3707188 (D.N.J.) (Exhibit Art. VIII. 8.5), at 26.

<sup>541</sup> *Id.*

<sup>542</sup> CHOI, *supra* note 424, at 184.

<sup>543</sup> See KWON, *supra* note 374, at 546.

<sup>544</sup> Sunggho Kim, *Evasion and Cure of In-kind Investment in the German Case Law*, 11 ANAHM L. REV. 323 (2000).

<sup>545</sup> DRBA, art. 416.

<sup>546</sup> *Id.* In the United States, the same chapters of the Bankruptcy Code are applied in both personal and corporate bankruptcies. Most individuals who enter bankruptcy do so under Chapter 13 (a “reorganization” plan) or Chapter 7 (a “liquidation” of debtor’s assets). A Shareholder may also, regardless of his or her status for corporation, file voluntary bankruptcy according to the Code. 11 U.S.C. §§ 7, 13 (2012).

KCA prohibits a set-off by the shareholders in order to secure the company's capital.<sup>547</sup> However, the Supreme Court of Korea has often cited<sup>548</sup> that there is no need to nullify the set-off by shareholders, if the company has agreed to it.<sup>549</sup> In accordance with the popular view in Germany and in case law,<sup>550</sup> set-off is permitted if the company has the ability to make repayments when its financing through claims is of equal value to the cash contribution.<sup>551</sup>

The doctrine of capital adequacy can be cited as another ground.<sup>552</sup> The first purpose of capital adequacy is to protect the company's creditors, with capital adequacy involving set-off also being discussed to protect the company's other creditors.<sup>553</sup> Thus, if some of the majority creditors made the debt-for-equity swap through a set-off for their claims, the result would be worse for the company's assets, as the reduction of debt prompts a relative increase in assets for other creditors.<sup>554</sup>

For example, let us assume that a company has net assets of KRW 10 million, while its debt to *A* is KRW 5 million out of a total company debt of KRW 20 million. In this situation, the value of *A*'s claim is proportionality worth KRW 2.5 million and the value of the other creditors' claims is KRW 7.5 million. If there is an agreement to make a debt-for-equity swap for *A*'s claim and the company issues new shares equal to KRW 5 million to *A*, the payment can be said to be insufficient. *A*'s claim amount of KRW 5 million and subscription price KRW 5 million are actually only equal to KRW 2.5 million, the proportional share of its net assets. However, it must be taken into consideration that the immediate value of the shares *A* will obtain is essentially zero.<sup>555</sup> On the

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<sup>547</sup> Cf. WILLIAM JOHNSTON & THOMAS WERLEN, SET-OFF LAW AND PRACTICE: AN INTERNATIONAL HANDBOOK 114 (2006) (explaining that the Commercial Code prohibits the set-off of a shareholder's claim).

<sup>548</sup> Daegu Fisheries Wholesale Mkt. Co. v. Seokdae Seo, S. Ct., 63Da494, Oct. 22, 1963 (S. Kor.).

<sup>549</sup> See *id.*

<sup>550</sup> See Wolfgang Zöllner (Hrsg.), *Kölner Kommentar zum Aktiengesetz* [Köln comment for Stock Act], Carl Heymanns Verlag KG (1998), at 797.

<sup>551</sup> See *id.* However in such a case, because no insolvent companies have the ability to repay the debt, those who have executed debt-for-equity swaps for loans with companies in Korea are following the next best policy for recovering debt. If this is so, the sufficient value theory affirmed in Germany is not suitable in the Korean situation where the debt-for-equity swap is made as a means of financial workout for defaulting companies.

<sup>552</sup> See BANK FOR INTERNATIONAL SETTLEMENTS, BASEL COMMITTEE ON BANKING SUPERVISION—OVERVIEW, <http://www.bis.org/bcbs/index.htm> (last visited Mar. 14, 2017) (find the most recent information from the Basel Committee on Banking Supervision (BCBS)).

<sup>553</sup> For failing corporations, "adequacy of capital is typically a major component of any solvency analysis." *Moody v. Sec. Pac. Bus. Credit, Inc.*, 971 F.2d 1056, 1071 (3rd Cir. 1992).

<sup>554</sup> See Lee, *supra* note 352, at 26.

<sup>555</sup> *Id.* In an appraisal of future earning power is crucial not only with respect to the treatment

other hand, due to the set-off, the company's debt is reduced to KRW 15 million, so the value of the other creditors' claims increased from the previous amount of KRW 7.5 million to KRW 10 million.

The doctrine denying the subscription price payment by set-off has been a popular one,<sup>556</sup> grounded in the principle of capital adequacy.<sup>557</sup> Professor Kwon argues that as long as Article 334 of the KCA is not abrogated, owing to the principle of capital adequacy, there is no genuine impact on the subscription price payment, as either the subscribers or the debtor corporation are the concerned parties to the set-off agreement.<sup>558</sup> Moreover, without any practical subscription price payment being made to the company, there is no difference regarding who makes the set-off, because the subscription price payment by set-off is a payment form in substitution for claims.<sup>559</sup> Therefore, it is in conflict with Article 421 of the KCA, which adopts the principle of full payment in cash.<sup>560</sup> According to the set-off denial theory, even when the subscription price payment by set-off is made, the payment of the amount of the subscription price does not take effect upon the issuance of new shares.<sup>561</sup> Therefore, the subscribers bear the obligation of paying the subscription price in cash again, and the directors and inspectors of the creditor company may be held liable to compensate for any damages.<sup>562</sup>

(2) *Case Law of Korea*: The Supreme Court of Korea held that subscription price payment by set-off was valid in a case where the plaintiff corporation alleged that its subscription payment claim against the defendant shareholder was assignable.<sup>563</sup> The issue in that case was whether the plaintiff's claim against the defendant for the subscription price could be assignable in light of the capital adequacy concept, and if so, whether it could be subject to usury law.<sup>564</sup>

The facts are as follows. The plaintiff corporation had a claim against Dukjoong Park, the defendant, in the amount of KRW 1,650,000 for a subscrip-

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of the set-off but with respect to other major issues dealt with in the corporate reorganization proceeding. In compounding future value and earning power, an interest rate is always assumed. See WARREN ET AL., *supra* note 458, at 507.

<sup>556</sup> See Kang, *supra* note 426, at 213; see also CHOI, *supra* note 424, at 184.

<sup>557</sup> *Id.*

<sup>558</sup> See KWON, *supra* note 374, at 546.

<sup>559</sup> *Id.*

<sup>560</sup> See *id.*

<sup>561</sup> *Id.*

<sup>562</sup> Minbeob [Civil Act], arts. 399, 401, 414 (S. Kor.).

<sup>563</sup> See Korean S. Ct., Civil Case Report II., Korea Textbook Printing Division, (1964), at 564; see also Shinheung Transp. Co. v. Deokjung Park, 4292 Minsang 915, Sept. 1, 1960 (S. Kor.).

<sup>564</sup> *Shinheung Transp. Co.*, 4292 Minsang at 915.

tion price payment, while Park had a claim of KRW 900,000 against the plaintiff for the use of an office building he owned.<sup>565</sup> The case involved the transfer of the plaintiff's claim.<sup>566</sup> The defendant should have paid the subscription price of the new shares, but delayed payment.<sup>567</sup> Therefore, the plaintiff's claim—the subscription price payment against the defendant—was assigned to Taikmo Lim in lieu of the plaintiff's debt to Lim.<sup>568</sup> If the defendant had paid his consideration, the plaintiff could have paid the debt owed to Lim.<sup>569</sup>

The Supreme Court of Korea affirmed the plaintiff's argument that the company's subscription price payment by set-off for the shareholders was valid, on the condition that the company's claim against the defendant was assignable.<sup>570</sup> However, another case reached a contrary result on facts involving nullification of the subscription price payment by set-off.<sup>571</sup>

On August 15, 1957, defendant Y, as a shareholder of plaintiff X corporation, made a novation contract with Z in which both agreed to terminate Y's obligation to Z instead of agreeing to pay the debt of KRW 1,788,110 on a note to be paid to the plaintiff corporation by Z on September 15 of the same year.<sup>572</sup> In addition, defendant Y agreed to make payment of the subscription price of KRW 200,000 to the plaintiff company in subscribing to the new shares as a result of an increase in the capital of the plaintiff corporation, which occurred on February 16, 1957.<sup>573</sup> The plaintiff made the payment substituting for the defendant, but two months of salary compensation totaling KRW 16,000 had not yet been repaid.<sup>574</sup> Accordingly, the plaintiff filed suit alleging that defendant should pay KRW 200,000 for the subscription fees for the new shares and KRW 892,090 on a note, which due to Z's neglect, the defendant assumed.<sup>575</sup>

Aside from the argument regarding what kind of contract was created between the plaintiff corporation and the defendant, the Korean Supreme Court concluded that there should be practical performance of the contract for the sub-

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<sup>565</sup> *Id.*

<sup>566</sup> *Id.*

<sup>567</sup> *Id.*

<sup>568</sup> *Id.*

<sup>569</sup> *Id.*

<sup>570</sup> *See id.*

<sup>571</sup> *See Daegu Fisheries*, 63Da494.

<sup>572</sup> *Id.* For ease of readability, party names have been substituted with letters in the accompanying text.

<sup>573</sup> *Id.*

<sup>574</sup> *Id.*

<sup>575</sup> *Id.*

scription price payment.<sup>576</sup> Otherwise, the obligation of performing the subscription price payment could be considered fully executed. Therefore, the Korean Supreme Court took a prohibitive stance in regard to subscription price payment by set-off.<sup>577</sup>

#### VI. DEBT-FOR-EQUITY SWAP IN THE CORPORATE REORGANIZATION PROCEEDING

When the object of a debt-for-equity swap is acquired by means of an indirect method that permits the subscription price payment by set-off, this procedure must be thoroughly reviewed, as it replaces the more rigid and complex in-kind investment procedure.

Along with reducing excessive debts, a debt-for-equity swap can be a means of coordinating the obligations used to adjust debts through negotiations with a debtor's creditors.<sup>578</sup> Ordinarily, such a process is also expressed as "securitization of debts" in the sense that debt on the balance sheets is being converted into securities (equity), making it virtually an asset of the company.<sup>579</sup>

As discussed herein, because current Korean law does not directly regulate debt-for-equity swaps, in-kind investment may inform swap procedures. The argument—with the exception to the prohibition of subscription price payment by set-off—is in accord with this rationale.<sup>580</sup> However, as the procedure for an in-kind investment is complex and cumbersome, parties seek more convenient indirect means. In other words, even though a debt-for-equity swap can be legally constructed by borrowing from the system of in-kind investment, because it is complex in practice, the subscription price payment by set-off as an alternative to the exception can be approved with the new interpretation of Article 334 of the KCA.<sup>581</sup> However, as described, the situation subject to the application of Article 334 of the KCA is one in which the financing for the healthy company is actually scheduled and the debt-for-equity swap as discussed here seems inap-

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<sup>576</sup> Supreme Court of Korea [S. Ct. Kor.], 64 Da 494, Oct. 22, 1963.

<sup>577</sup> *Id.*

<sup>578</sup> Southgate Master Fund, LLC ex rel. Montgomery Capital Advisors, LLC v. United States, 651 F.Supp.2d 596, 644–45 (N.D. Tex. 2009).

<sup>579</sup> Issuer Review of Assets in Offerings of Asset-Backed Securities (Release No. 33-9150; File No. S7-26-10), 2010 WL 5545730 (Dec. 14, 2010), at 4 ("Unlike traditional asset-backed securities, . . . Corporate Debt Repackagings are not part of the process of directly or indirectly financing the origination of consumer loans or other financial assets. Instead, they represent the reoffering of existing debt securities of corporate issuers acquired in the secondary market.").

<sup>580</sup> See Lee, *supra* note 352, at 18.

<sup>581</sup> See KCA art. 334.

plicable.<sup>582</sup> In case of permitting an exception to the prohibition of subscription price payment by set-off, distinguishing the company to which an exception to Article 334 of the KCA will be applicable becomes an exercise in ambiguity that can result in shaking the foundation of the principle of capital adequacy.<sup>583</sup>

*A. Issuance of Shares During the Reorganization Proceeding*

*1. Issuance of New Shares*

Corporate reorganization law contains a provision on receiving new shares without making payments or involving investments-in-kind by unsecured or secured creditors.<sup>584</sup> The following paragraphs explain the relevant details.

Article 206, Clause 1 of the DRBA provides that a company may issue new shares without requiring the secured or unsecured creditors or shareholders to make new payments or contributions-in-kind.<sup>585</sup> Under this Article, without making the subscription price payment, creditors can change their claims against the company into shares through a debt-for-equity swap.<sup>586</sup>

The usefulness of this system can be explained in four parts. First, when a company lacks financial resources to make payments on secured and unsecured claims, it can substitute payment with shares, thus reducing the amount of payments in cash needed and increasing the possibility of carrying out the reorganization plan. Second, from the standpoint of the unsecured creditors, instead of suffering from an extended repayment period or reduction in claims, converting their claims into shares enhances their likely guarantee of compensation because the assets and equity value is sharply increased, which may contribute to an operating profit in the future. Third, unsecured creditors can become controlling shareholders by converting their claims into stock and looking for new management or by conveying their shares to a third party. Fourth, bank creditors can reduce their bad loans and increase equity capital.

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<sup>582</sup> See GMO Core Trust, Application File No. 812-6388 (Oct. 7, 1986), Securities and Exchange Commission (S.E.C.) Release No.15350, 36 S.E.C. Docket 940, 51 FR 36622, 1986 WL 625769, at 2. In the U.S., the securities acquired by the fund or portfolio in an in-kind investment or distributed to an affiliated shareholder, under the Investment Company Act of 1940, pursuant to a redemption in-kind will be limited to Securities listed on a securities exchange or Securities for which quoted bid prices are available. *Id.*

<sup>583</sup> See Harizuka, *supra* note 361, at 8. The debt-for-equity swap for loans can be available not only to insolvent companies subject to corporate reorganization law due to an aggravated financial crisis, but also to normal companies. *Id.*

<sup>584</sup> See Eisenbach, *supra* note 388.

<sup>585</sup> DRBA, art. 206 (S. Kor.).

<sup>586</sup> *Id.*

## 2. *Debt-for-Equity Swap Method*

Two methods exist for conducting a debt-for-equity swap: (i) granting junior creditors the option to buy the rights of senior creditors,<sup>587</sup> or (ii) allowing a debt-for-equity swap only to unsecured creditors.<sup>588</sup> The first method, which is a theory suggested by Professor Bebchuk, grants the purchasing option to junior creditors and distributes the value of the company among the creditors.<sup>589</sup> However, the problem with Bebchuk's method is that the junior creditors must have cash to maximize their profits.<sup>590</sup> The second method, which is a theory proposed by Aghion, Hart, and Moore, issues shares of the company to unsecured creditors while keeping secured creditors' claims intact, thus removing all the unsecured claims.<sup>591</sup> At this time, some of the shares can also be given to the existing shareholders.<sup>592</sup> Furthermore, it is possible to use a hybrid of these two methods.

In other words, by keeping the secured claims within the value of the security interest, the company converts either the unsecured claims or the secured claims into shares out of the two claims. This conversion exceeds the security values by the proportion of the claim amounts and grants the option to the existing shareholders to purchase the shares owned by unsecured creditors at the face value of the claims.

In Korean corporate reorganization, the conversion right is given to both unsecured and secured creditors.<sup>593</sup> However, the ratio of claims in a debt-for-equity swap is decided in accordance with the report prepared by the investigative accounting firm appointed by the court.<sup>594</sup>

### *B. Stated Items in the Reorganization Plan and Miscellaneous*

In the reorganization plan, the number and kinds of new shares, the details

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<sup>587</sup> See Lucian Arye Bebchuk, *A New Approach to Corporate Reorganizations*, 101 HARV. L. REV. 775 (1988).

<sup>588</sup> See Philippe Aghion, Oliver Hart & John Moore, *Improving Bankruptcy Procedure* 14 (Harv. Inst. Econ. Res., Discussion Paper No. 1672, 1994); see also Philippe Aghion, Oliver Hart & John Moore, *Improving Bankruptcy Procedure*, 72 WASH. U. L. Q. 849, 856 n.17 (1994) (hereinafter Aghion et al., WASH. U.).

<sup>589</sup> See Bebchuk, *supra* note 587, at 775.

<sup>590</sup> *Id.*

<sup>591</sup> See Aghion et al., WASH. U., *supra* note 588, at 856.

<sup>592</sup> *Id.*

<sup>593</sup> Bebchuk, *supra* note 587, at 775.

<sup>594</sup> See, e.g., Bebchuk, *supra* note 587, at 775; Douglas G. Baird, *A World Without Bankruptcy*, 50 LAW & CONTEMP. PROBS. 173, 192-93 (1987). Conversion of debt to equity is not an unusual idea, and this financial skill is the cheapest and fastest way to reorganize a company. *Id.*

of the allotment of new shares, the capital to be increased as a result of the new issuance of shares, and the reserve fund to be increased by the new stock issuance should be stated.<sup>595</sup> It is likely that preferred stock will be used for the new shares. In allotting the new shares—taking the claim’s priority order into consideration as set forth in Article 217 of the DRBA—a fair and equitable judgment shall be made depending on such things as the ratio of allotment or the degree of the impairment of the priority creditor’s claims.<sup>596</sup> Particularly when the new shares are given only to specific secured creditors while the other secured creditors are required to make payments in cash, the ratio of stock allotment needs to be adjusted to avoid a violation of the principle of equality.<sup>597</sup>

According to Article 206, Clause 1 of the DRBA, when a decision to issue new shares is made without making an in-kind investment or new payments to unsecured and secured creditors and shareholders, despite the provisions regarding preemptive rights granted in the certificate of incorporation, the shares can be allotted not only to the existing shareholders, but to others without being restricted by the provisions.<sup>598</sup> This is because there are many cases where new shares shall be allotted not only to the existing shareholders, but also secured and unsecured creditors in the process of the corporate reorganization.<sup>599</sup>

Under the KCA, the effective date of the new shares is the day after the payment date.<sup>600</sup> When the company capitalizes the reserve fund or issues new shares without an in-kind investment or new payment, as in the case of a stock split, resolutions must be made during the general shareholders’ meeting.<sup>601</sup> In contrast, in a corporate reorganization proceeding, if the reorganization plan requires the company to issue new shares without a new payment or contribution-

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<sup>595</sup> DRBA, art. 206, cl. 1.

<sup>596</sup> See *In re Dow Corning Corp.*, 244 B.R. 696, 705 (Bankr. E.D. Mich. 1999). Under 11 U.S.C. § 1129(b)(2)(B), a plan will be deemed “fair and equitable” if either “(i) the plan provides that each holder of a claim of such class receive or retain on account of such claim property of a value, as of the effective date of the plan, equal to the allowed amount of such claim; or (ii) the holder of any claim or interest that is junior to the claims of such class will not receive or retain under the plan on account of such junior claim or interest any property.” *Id.*

<sup>597</sup> See THOMAS J. SALERNO & JORDAN A. KROOP, *BANKRUPTCY LITIGATION AND PRACTICE: A PRACTITIONER’S GUIDE* 8–129 n.542 (4th ed. 1995) (citing *In re Spanish Lake Associates*, 92 B.R. 875 (Bankr. E.D. Mo. 1988)). The principle of equality applies in many legal areas, i.e., constitutional challenge, employment litigation, contract and bankruptcy law. *Id.* “In *In re Woods Group*, the Ninth Circuit identified 10 factors for determining whether a negative amortization plan is fair and equitable.” *Id.*

<sup>598</sup> DRBA art. 206, cl. 1 (S. Kor.).

<sup>599</sup> As to the impact on the shareholders’ right to subscribe to new shares, it is inevitable the shareholders accept the sacrifice for the purpose of the corporate reorganization in a financial emergency such as a bankruptcy proceeding.

<sup>600</sup> *Minbeob* [Civil Act], art. 423, cl. 1.

<sup>601</sup> KCA art. 461, cl. 4, art. 462, cl. 4 (S. Kor.).



in-kind by the unsecured and secured creditors or shareholders, those right holders become shareholders when the plan is approved or at a time specified in the plan.<sup>602</sup>

There is an argument regarding allocating an odd number of shares to reorganization secured and unsecured creditors.<sup>603</sup> In other words, there are two divided opinions, with one alleging that Articles 440 through 444 of the KCA, which discuss the stock merge process, must be applied *mutatis mutandis* to an odd number of shares, while the other alleges that the above-mentioned KCA provisions cannot be applied, as there is no express provision in the DRBA.<sup>604</sup> Considering the DRBA does not have express provisions, and considering the difficulty associated with administering the prescribed process for a stock merger, this Article advocates for the latter/second opinion.<sup>605</sup>

In the end, the reorganization plan dictates the treatment method used, but this Article takes the position that where there is a stipulation on the treatment of odd shares for reorganization secured or unsecured creditors, the shares should be forfeited.<sup>606</sup> In addition, when the odd shares come after a decision to issue the new shares for secured or unsecured claims, it may be argued that leaving only the claims pertaining to the odd stock is positive, but the opposite view seems more logical.<sup>607</sup> On the other hand, unsecured and secured creditors can waive their rights to a portion of the odd shares.<sup>608</sup>

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<sup>602</sup> DRBA art. 265, cl. 1 (S. Kor.). In the past, the issuance of new shares became effective when the reorganization plan was approved, but the capital reduction and issuance of new shares occurring simultaneously created issues. Specifically, stock merger became effective at the deadline for submitting certificates, whereas the effect of new shares began at the time of reorganization plan approval. This made the issuance of new shares effective before the reduction in capital took place. For a temporary period, the number of issued shares became excessive and the question arose whether stock merged only for old shares or after the issuance of new shares. Thus, to prevent such a case from occurring, in 1998 the KCRA was amended to designate the effective time of the new issuance of shares. See Kim Pil-Kyu, *Changes in Corporate Restructuring Regulation and the Impact on the Capital Markets*, KCMi CAPITAL MKT. OP. 1–6 (May 3, 2016); see also 26 C.F.R. § 1.382–9 (providing special rules under section 382 for corporations under the jurisdiction of a court in a title 11 or similar case).

<sup>603</sup> See Jirō Matsuda, *Kai-sha-kō-sei-hō* [*Corporate Reorganization Law*] at 36 (Yūhikaku, 1990) (Japan).

<sup>604</sup> See Akira Mikazuki et al., *Jo-kai-kai-sha-ko-sei-ho Ha* [*Corporate Reorganization Law*] Vol.3 at 848 (2003) (Japan).

<sup>605</sup> See Kyeongwhan Seo, *Jeong-ni-hoi-sa-eui-sin-ju-bal-hang* [*New Stock Issuing of Reorganizing Corporation*], at 152 (Practitioner's Working Forum, Seoul Dist. Ct.) (1997) (S. Kor.).

<sup>606</sup> See Mikazuki, *supra* note 607, at 927.

<sup>607</sup> *Id.*

<sup>608</sup> *Id.*

*C. Shareholders' and Creditors' General Meetings*

In order to make a debt-for-equity swap on a nonperforming loan, the certificate of incorporation must be changed by a special resolution at the shareholders' general meeting to increase the number of authorized shares to be issued. For the debt-for-equity swap to be attractive, there needs to be a proper reduction in capital. When such a special resolution is needed to increase the number of authorized shares, the existing shareholders may dissent because the capital reduction would decrease the value of their voting rights, and they would fail to maintain their possession ratio on the stock.<sup>609</sup>

In addition, if the price of newly issued stocks is excessively high, the creditors may not agree to a debt-for-equity swap plan. Persuading dissenting creditors when par value stock is to be issued below par brings in another knotty problem relating to the stock value. Unless the issues are subject to bankruptcy law, resolving the capital reduction issue is difficult because it can become entangled with other complex issues.

When a company is in or near bankruptcy, it must reduce its debts to survive.<sup>610</sup> Failure to do so could result in a transfer of wealth from the company creditors to existing shareholders.<sup>611</sup>

Therefore, when liabilities exceed assets, both a 100% reduction in capital and an issuance of new shares may be executed together. However, a special resolution is unlikely to be passed by the shareholders of a company whose liabilities exceed assets.<sup>612</sup>

## VII. SEVERAL VEHICLES FOR DEBT-FOR-EQUITY SWAP INVIGORATION

The debt-for-equity swap can be beneficial to both the company and the creditors if it improves the company's financial structure. However, from the creditors' standpoint, there is risk in converting claims to equity because uncertainty exists as to whether losses may increase, and from the controlling shareholders' standpoint, there is a risk of losing management rights.<sup>613</sup>

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<sup>609</sup> *In Re TRICOM, S.A., et al.*, 2008 WL 7928513, at 84 (Bankr. S.D.N.Y. 2008).

<sup>610</sup> The purpose of a reorganization plan is to reduce debts within appropriate financial structures and fixed charges. See John H. Frye, III, *The "Fair and Equitable" Doctrine: Are Liquidation Rights a Realistic Standard During Corporate Reorganization?*, 20 CATH. U. L. REV. 403 (1970).

<sup>611</sup> See *id.*

<sup>612</sup> See, e.g., Rafael Sebastián & Jaime Pereda, *Insolvency Proceedings in Spain - An Overview of the Proposed Insolvency Law*, in CORPORATE RESCUE: AN OVERVIEW OF RECENT DEVELOPMENTS FROM SELECTED COUNTRIES IN EUROPE 120–21 (Katarzyna Gromek Broc & Rebecca Parry eds., 2004).

<sup>613</sup> Risk management by financial device such as the debt-for-equity swap is useful for market

Against such a theoretical background, a good point from the company owner's perspective is that the right of management can be maintained when either convertible or exchangeable bonds are issued, rather than simple stock in consideration for the debt so as to activate the debt-for-equity swap.<sup>614</sup> From the banks and the creditors' committees' standpoint, this may be attractive, as it can reduce the risk posed by stocks.<sup>615</sup>

However, as a conversion claim can be made after waiting a year to exercise the conversion right on private convertible bonds, there needs to be an exceptional measure introduced into the above-mentioned case to secure effectiveness. From this viewpoint, exchangeable bonds as a new means of financing can be a good alternative to preventing conversion of the private convertible bonds for a year.<sup>616</sup>

Next, no-par stock can help make financing easy without changing the certificate of incorporation or a special resolution at a general shareholders' meeting, even if the stock price is below its face value.<sup>617</sup> At the same time, as financing with no-par stocks can increase the possibility that claims will be repaid, it benefits both creditors and the company.<sup>618</sup> Therefore, no-par stock needs to be introduced to activate the debt-for-equity swap.

Moreover, to make debt-for-equity swaps more attractive, Tracking Stocks (TS) can be introduced to track the performance of a target business.<sup>619</sup> This method is often used by start-up venture companies in the United States.<sup>620</sup> To introduce this system, legal infrastructure should be improved, such as amending Article 344 of the KCA, because it can be very useful in corporate reorganizations and mergers.<sup>621</sup> To construct the right TS for the actual circumstances in Korea, creditors can ask the debtor corporation for stock issued on a business with good profitability at the time of the debt-for-equity swap. From the company's standpoint, it will have more elasticity in financing, as it can issue stocks

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participants. See 15 U.S.C. §78o-10 (2012) (providing registration and regulation of security-based swap dealers and major security-based swap participants).

<sup>614</sup> Convertible bonds are one of the major vehicles in the financial market. See George W. Dent, Jr, *The Role of Convertible Securities in Corporate Finance*, 21 J. CORP. L. 243 (1995–96).

<sup>615</sup> See *id.* at 243–44.

<sup>616</sup> 26 C.F.R. § 1.171–1(e)(1)(iii)(B)–(C) (2013).

<sup>617</sup> *In re* Declaration of National Gas & Electric Corporation, 2 S.E.C. 632 (S.E.C. Release No. 357, 1937), 1937 WL 32925, at 1–7.

<sup>618</sup> See JOEL G. SIEGEL & JAE K. SHIM, *BARRON'S ACCOUNTING HANDBOOK* 570–71 (4th ed. 2006).

<sup>619</sup> *Tracking Stocks*, SEC (Sept. 3, 2004), <https://www.sec.gov/answers/track.html>.

<sup>620</sup> *Id.*

<sup>621</sup> See *id.*

in additional ways.<sup>622</sup>

Finally, the asset-backed securities (ABS) system has been aggressively used by financial institutions of late because it separates originators from assets. The ABS system can offer chances for new creditors to use securitization and original creditors to change their creditor status in relation to the debt-for-equity swap.<sup>623</sup> It expands the demand base for the debt-for-equity swap so that a greater variety of creditors can review it.<sup>624</sup> This subchapter will address several vehicles for debt-for-equity swaps.

#### *A. Debt-for-Equity Swap by Issuing Convertible Bonds*

To use a debt-for-equity swap, rather than using simple stock in exchange for obligations, companies can offer convertible bonds—bonds with an option for conversion into stock.<sup>625</sup> These have the advantages of maintaining the owners' management rights and holding less risk than stock for banks and creditors' committees.<sup>626</sup>

However, when convertible bonds are issued, liabilities or interest rates experience little reduction in relation to the value of the convertible option, and the reduction effect on the debt ratio is slight.<sup>627</sup> By using the debt-for-equity swap for claims, the company issues convertible bonds equal to the amount of creditor claims and converts them into shares.

In a convertible bond, debts with acknowledged rights will be converted into stocks.<sup>628</sup> In making a debt-for-equity swap, as is true with general debts being used for payment of convertible bonds, Article 334 of the KCA is not ap-

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<sup>622</sup> See *id.*

<sup>623</sup> See Kenneth M. Ayotte & Stav Gaon, *Asset-Backed Securities: Costs and Benefits of 'Bankruptcy Remoteness'*, 24 REV. FIN. STUD. 1299 (May 14, 2006), <https://www.newyorkfed.org/medialibrary/media/research/conference/2006/cffi/Ayotte.pdf> (stating recent empirical research confirms that ABS seems motivated more by efficient contracting motives than by regulatory arbitrage).

<sup>624</sup> See Daniel H. Cole, *Debt-Equity Conversions, Debt-for-Nature Swaps, and the Continuing World Debt Crisis*, 30 COLUM. J. TRANSNAT'L L. 57, 58 (1992).

<sup>625</sup> See generally *Aristocrat Leisure Ltd. v. Deutsche Bank Trust Co. Americas*, 618 F. Supp. 2d 280, 304 (S.D.N.Y. 2009) (pointing out the “[p]urchasers of convertible bonds would reasonably assume that the issuer of convertible bonds knew, understood, and accepted that many purchasers would engage in the common practice of short selling the underlying shares. . . . Purchasers of convertible bonds would also reasonably assume that the issuer of convertible bonds knew, understood, and accepted that if it did not deliver shares upon conversion at least some bondholders would be left with an open short position.”).

<sup>626</sup> SUBHRENDU CHATTERJI & PAUL HEDGES, *LOAN WORKOUTS AND DEBT FOR EQUITY SWAPS: A FRAMEWORK FOR SUCCESSFUL CORPORATE RESCUE* 270 (2001).

<sup>627</sup> See Dent, *supra* note 614, at 243.

<sup>628</sup> See *id.*

plicable.<sup>629</sup> Therefore, when the creditors of a company make the payment's set-off for the convertible bonds and make the conversion into stock, the debt-for-equity swap is made.<sup>630</sup>

This has the advantage of avoiding the rigid and complex process of in-kind investment, but is inconvenient in that it requires both the issuance of convertible bonds and exercise of conversion rights.<sup>631</sup> Moreover, when private convertible bonds are issued, the conversion right can be exercised a year after the waiting period under Korean law, but there is doubt as to its effectiveness.<sup>632</sup> However, no public subscription can occur while making a debt-for-equity swap.<sup>633</sup> The debt-for-equity swap using convertible bonds can be activated if special measures are triggered to treat failing companies by allowing the issuance of private convertible bonds.

### *1. Issuing Convertible Bonds*

As the creditors become shareholders upon the exercise of their conversion rights, the convertible bonds become practically the same as new shares, where the old shareholders' rights to the stake are also directly affected. Therefore, in the case where convertible bonds are issued to non-shareholders and the certificate of incorporation does not include the amount of convertible bonds to be issued, the conditions of conversion, the contents of the shares to be issued upon conversion, and the period during which the conversion may be demanded must be determined by a resolution at the shareholders' general meeting.<sup>634</sup>

Corporate reorganization plans must disclose whether they require the issuance of convertible bonds.<sup>635</sup> However, in the case of an insolvent company, when the convertible bonds are issued after a complete or extensive reduction of capital, dissension by the existing shareholders may present an issue. This Article opines that the best way to issue convertible bonds is via an agreement to be

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<sup>629</sup> CHATTERJI & HEDGES, *supra* note 626, at 270.

<sup>630</sup> *Id.* ("Depending on the country, there are usually various restrictions on the circumstances under which such conversion can be carried out.").

<sup>631</sup> In addition, "convertibles protect investors from deceit: if stock proves less valuable than the issuer represented, the investors keep the senior security and the shareholders bear the loss." See Dent, *supra* note 614, at 58.

<sup>632</sup> KCA arts. 346–51.

<sup>633</sup> See EUROPEAN COMMISSION & IMF, SYSTEM OF NATIONAL ACCOUNTS 2008 447 (2009) ("The creditor exchanges the debt claim for something of economic value, other than another debt claim, on the same debtor.").

<sup>634</sup> KCA art. 513, cl. 3 (S. Kor.).

<sup>635</sup> See Investor Publications, *Bankruptcy: What Happens When Public Companies Go Bankrupt*, SEC (Feb. 3, 2009), <https://www.sec.gov/investor/pubs/bankrupt.html>.

reached at the creditors' meeting between the company's creditors and existing shareholders.

Under the KCA, issuance of convertible bonds cannot exceed four times the amount of the existing net worth of the company as reflected on the final balance sheets.<sup>636</sup> However, if the bond offering is made for the purpose of redeeming old bonds, the amount of the old bonds shall not be computed in the total amount of the bonds.<sup>637</sup> Therefore, it may be difficult for an insolvent company to make a debt-for-equity swap for the claims by issuing convertible bonds. However, this difficulty is nonexistent in publicly held stock companies and Korea Securities Dealers Association Registered Corporations, as there is no restriction on the amount that can be issued corresponding to their stock convertible portions.<sup>638</sup>

## 2. *Converting Convertible Bonds*

During the period of conversion, stock conversions can be made at any time by a unilateral declaration of intent by the bondholders.<sup>639</sup> At that time, the bonds handed to the company for conversion become null and void, and the subrogation of the pledge is approved by the conversion for the pledgee.<sup>640</sup> Thus, in the conversion of shares, a pledge regarding the original shares may be extended to the money or shares that the original shareholder is to receive. As in the issuance of new shares, the number of outstanding shares increases, and consequently, so does the company's capital.

When private convertible bonds are issued in connection with the conversion period, the right to exercise shall take place a year after the issuance date.<sup>641</sup> The reason for such a provision is to prevent the side effects that follow the issuance and immediate conversion of convertible bonds into shares by allies with third-parties who might intervene in management when a hostile takeover or merger is about to take place.<sup>642</sup> However, the issuance of convertible bonds requires a special resolution by the shareholders' general meeting or a provision in

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<sup>636</sup> KCA art. 470, cl. 1 (S. Kor.). This rule was enacted to establish corporate capital adequacy by prohibiting exceeding of the debt finance ratio of the corporation.

<sup>637</sup> KCA art. 470, cl. 3 (S. Kor.).

<sup>638</sup> KSEA art. 191–95 (S. Kor.).

<sup>639</sup> See Dent, *supra* note 614, at 243.

<sup>640</sup> KCA art. 516, cl. 2 (S. Kor.); *Id.* art. 339. “[W]hen the doctrine of subrogation applies, the subrogee succeeds to the legal rights and claims of the subrogor with respect to the loss or claim.” *In re Flamingo 55, Inc.*, 378 B.R. 893, 905–06 (U.S. Bankr. D. Nev. 2007).

<sup>641</sup> See FRANK J. FABOZZI, *HANDBOOK OF FINANCE, FINANCIAL MARKETS AND INSTRUMENTS* 319–24 (2008).

<sup>642</sup> See Dent, *supra* note 614, at 254.

the certificate of incorporation where concrete management purposes exist.<sup>643</sup> Even if the possibility of abuse remains, an exception is permitted when the convertible bonds are used in the corporate reorganization of an insolvent company.<sup>644</sup>

*B. Debt-for-Equity Swap by Issuing Exchangeable Bonds*

*1. Issuing Exchangeable Bonds*

Currently, exchangeable bonds are being used as a means of corporate financing.<sup>645</sup> This is because exchangeable bonds can be granted as consideration for debt-for-equity swaps, and their right of conversion cannot be exercised for a year from the date of issuance.<sup>646</sup> Exchangeable bonds are entitled to dividends and contain the right to demand an exchange with stock, other securities, or other bonds owned by the bond-issuing company.<sup>647</sup>

At one time, exchangeable bonds could only be exchanged with negotiable securities, such as company stock other than the bond-issuing company's own stock, but this provision has been transferred to a new act.<sup>648</sup> Exchangeable bonds are regulated by the Financial Investment Services and Capital Market Act and can only be issued by KSE-listed corporations or KOSDAQ-registered corporations.<sup>649</sup> The company issues exchangeable bonds to its creditors, which the company creditors can use as set-off for their claims that constitute the payment for the exchangeable bonds.

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<sup>643</sup> *See id.*

<sup>644</sup> The Korean economy was deeply impacted by the Asian crisis in 1997; consequently, the government drove nationwide corporate reorganization. *See* Kihwan Kim, Presentation at The High-Level Seminar on Crisis Prevention in Emerging Markets, Organized by The International Monetary Fund and The Government of Singapore, The 1997–98 Korean Financial Crisis: Causes, Policy Response, and Lessons (July 10–11, 2006), <https://www.imf.org/external/np/seminars/eng/2006/cpem/pdf/kihwan.pdf>.

<sup>645</sup> WILLIAM L. MEGGINSON, BRIAN M. LUCEY, SCOTT B. SMART, INTRODUCTION TO CORPORATE FINANCE, 136 (2008).

<sup>646</sup> *See* Jacques Henrot, Joanna Gumpelson and Samuel Giorgi, De Pardieu Brocas Maffei, *Debt-Equity Swaps in France: recent developments*, (Thomson Reuters Practical Law) (Mar. 1, 2012 (stating case study of Akerys Restructuring)).

<sup>647</sup> KSEA art. 191-4, cl. 1 (S. Kor.); KSEA Enforcement Decree art. 84-13, cl. 1 (S. Kor.).

<sup>648</sup> *See* Financial Investment Services and Capital Markets Act Art. 165-11 (Act No. 12383); Dec.176-13 (Dec. No.25050); KCA art. 469 (2).2. (Act No.12591); James Moloney, Glenn Pollner, & Matthew Shaw, *Convertible Debt Exchange Offers: Considerations for Distressed Issuers*, DEAL LAWYERS (Sep.–Oct. 2009), <http://www.gibsondunn.com/publications/Documents/Moloney-Pollner-Shaw-ConvertDebtExchangeOffers.pdf>.

<sup>649</sup> KSEA art. 191-4, cl. 1 (S. Kor.).

## 2. *Depositing Listed Negotiable Securities*

When issuing exchangeable bonds, the KSE-listed or KOSDAQ-registered corporation shall make a deposit of listed negotiable securities or registered negotiable securities with the Korea Securities Depository until conversion claims are made by other creditors or the deadline for conversion claims on its own bonds is reached.<sup>650</sup> Thus, the Korea Securities Depository can manage the concerned company's negotiable securities by marking them entrusted property.<sup>651</sup>

## 3. *Making a Claim on the Conversion and its Effects*

To exercise their exchange rights, the creditors of the exchangeable bond-issuing company who demand the exchange submit two copies of a written demand form together with the bond certificates to the company.<sup>652</sup> When exchangeable bonds are issued and a claim of exchange is made to carry out the debt-for-equity swap, the exchange claim can only be made against the shares of the concerned company.<sup>653</sup> There is no need for company approval, as the exchange claim is a right created when exercised.<sup>654</sup> Because the exchangeable bonds have nothing to do with the shareholders' list, exchange claims can be processed during the closed period of the shareholders' list. The effect of the exchangeable bonds begins when the claim is made.<sup>655</sup> Exchange claims can be made when the books are closed, but when the negotiable securities (negotiable instruments) are stock, voting rights cannot be exercised on the resolution of the shareholders' general meeting.<sup>656</sup>

## C. *Debt-for-Equity Swap by No-Par Stocks*

### 1. *Significance*

For a company that intends to restructure using a debt-for-equity swap even though its stock's market price is below par value, the legal procedures under the current KCA, such as changing the certificate of incorporation or obtaining a special resolution from the shareholders' general meeting, are very com-

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<sup>650</sup> KSEA Enforcement Decree art. 84-13, cl. 3, ¶ 1 (S. Kor.).

<sup>651</sup> KSEA Enforcement Decree art. 84-13, cl. 3, ¶ 2 (S. Kor.).

<sup>652</sup> KSEA Enforcement Decree art. 84-13, cl. 4; KCA art. 349, cl. 1 (S. Kor.).

<sup>653</sup> KSEA Enforcement Decree art. 84-13, cl. 3 (S. Kor.).

<sup>654</sup> KSEA Enforcement Decree art. 84-13, cl. 4; KCA art. 350, cl. 1 (S. Kor.).

<sup>655</sup> KSEA Enforcement Decree art. 84-13, cl. 4; KCA art. 350, cl. 1 (S. Kor.).

<sup>656</sup> KSEA Enforcement Decree art. 84-13, cl. 4; KCA art. 350, cl. 2 (S. Kor.).



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In addition, under the par value system, to improve the financial structure and chances of company revival through immediate financing, dissenting shareholders bear legal contribution obligations regardless of the number of shares to be issued that exceed the face amount of the par value.<sup>657</sup> On the other hand, in the case of no-par-value stock, the financing burden is borne with the subscription amount that results from the contract between the company and the subscribers.<sup>658</sup>

Therefore, shareholders with par value stocks are not completely exempted from contribution obligations by the performance of the subscription contract.<sup>659</sup> However, shareholders with no-par-value stock fulfill their financing obligation by the performance of the subscription contract and have no responsibility for further payments.<sup>660</sup>

With in-kind investment in particular, when par-value stock is issued, the shareholders bear the responsibility of the payment shortage but do not have the responsibility for no-par-value stock, the effect of which is striking.<sup>661</sup> However, because transparent management of the company must be secured as an essential prerequisite to achieve such an effect, and considering that a company subject to corporate reorganization will be under the due diligence scrutiny of accounting firms, the problem can be solved naturally.

Finally, issuance of no-par-value stock allows for relatively easy and quick financing in which the creditors of the company will be satisfied.<sup>662</sup> When an insolvent company is subject to corporate reorganization law, a failure of financial restructuring means the loss of all claims by the company creditors.<sup>663</sup> This does, however, increase the possibility of success for corporate reorganization as a result of company financing through the issuance of no-par-value stock, pursuant to which the company creditors will have a higher collection rate on their claims.<sup>664</sup> Thus, if a system of no-par-value stock can be used in the debt-for-equity swap, it benefits the company, shareholders, and creditors alike.<sup>665</sup>

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<sup>657</sup> See WARREN ET AL., *supra* note 458, at 438.

<sup>658</sup> The par value of a stock is simply its legal capital. *Id.* Under a no-par-value system, the stock may be sold by a corporation depends on a variety of factors i.e., past earning record, potential earning power, financial condition, dividend history, business prospects. *Id.*

<sup>659</sup> *Id.*

<sup>660</sup> See Seungbum Kim, *supra* note 52, at 132–33.

<sup>661</sup> *Id.*

<sup>662</sup> *Id.*

<sup>663</sup> *Id.*

<sup>664</sup> *Id.*

<sup>665</sup> HENN & ALEXANDER, *supra* note 508, at 400.

## 2. Relationship between Capital and Stock

As for the no-par-value stock, the relationship between capital and stock is broken, since there is no standard amount to serve as a consistent unit of equality for capital.<sup>666</sup> In a sense, the formula for the total capital amount being equal to the total amount of the subscription price payment does not hold.<sup>667</sup> Therefore, no-par-value shares are meaningless as a consistent unit of equality for capital.<sup>668</sup> The no-par-value stock is only a proportionate aliquot part to the total number of the outstanding shares and represents a proportionate or fractional unit of the assets and business of a company.<sup>669</sup>

In the United States, where the issuance of no-par-value stock is permitted, the capital structure is different from that permitted under the KCA, which only allows the issuance of face value stock to sever the relationship between capital and stock.<sup>670</sup> Under the KCA, the total amount of the outstanding shares constitutes the capital.<sup>671</sup>

In most U.S. states, the stated capital consists of the total face amount of the par value stock, the issue amount of the no-par-value stock minus the portion of the paid-in surplus, plus the sum of the stated capital transferred.<sup>672</sup> However, depending on the legal system, the stated capital is made up of the total amount of the paid-in capital by the issuance price, even with no-par-value stock.<sup>673</sup>

When part of the issuance price of no-par-value stock is allotted to the paid-in surplus, the ratio of the allotment of the surplus becomes an issue. In the state of Michigan, 50% of the price of the issuance paid-in can be the paid-in surplus.<sup>674</sup> The California General Corporation Law of 1975 and the Revised Model Business Corporation Act (“RMBCA”) of 1984 abolished the notions of face value and stated capital.<sup>675</sup>

The reason for abandoning the notion of the stated capital lies in the fact that neither the stated capital nor the system of legal capital protects the interests

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<sup>666</sup> See Seungbum Kim, *supra* note 52, at 132–33.

<sup>667</sup> *Id.*

<sup>668</sup> *Id.*

<sup>669</sup> See FLETCHER, *supra* note 403, at 146–48.

<sup>670</sup> *Why Would a Stock Have No Par Value?*, INVESTOPEDIA, <http://www.investopedia.com/ask/answers/106.asp> (last visited Mar. 21, 2017).

<sup>671</sup> KCA art. 451 (S. Kor.)

<sup>672</sup> See HENN & ALEXANDER, *supra* note 508, at 876; see also NY Bus. Corp. Law § 506; Del. General Corp. Law § 154.

<sup>673</sup> See FLETCHER, *supra* note 403, at 14.

<sup>674</sup> See *id.* at 147.

<sup>675</sup> See HENN & ALEXANDER, *supra* note 508, at 255–56.

of the company creditors.<sup>676</sup> Accordingly, the RMBCA abandons the “surplus test,” a method that limits profit sharing based on the stated capital, and adopts the “net assets test” that bases the limit of profit sharing on the net assets of the company.

Some states adopt the insolvency test that prohibits dividends when the company is insolvent.<sup>677</sup> While, most states that permit issuance of no-par-value stock acknowledge the interconversion between the face value stock and the no-par-value stock, this conversion does not necessarily result in an increase in capital.<sup>678</sup> The KCA is so bound up in the notion of capital that it cannot view flexible financial market situations from the correct angle.

### 3. Discussion

In Korea, unlike the United States, for a debt-for-equity swap to be completely executed through the system of no-par-value stock, problems must first be resolved, such as the issue price, the capital structure, and the guarantee on accounting transparency.<sup>679</sup> However, for a company that is subject to corporate

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<sup>676</sup> See LEWIS D. SOLOMON & ALAN R. PALMITER, CORPORATIONS (EXAMPLES & EXPLANATIONS) 255 (Aspen Law & Bus., 1999).

<sup>677</sup> See HENN & ALEXANDER, *supra* note 508, at 895.

<sup>678</sup> See FLETCHER, *supra* note 403, at 238–39.

<sup>679</sup> The corporate reorganization systems of Korea and Japan, although both having adopted U.S. law, are quite different in terms of the reorganization plan, preparation, and practice. In the United States, the word reorganization takes on a literal meaning with regard to the content of the reorganization of the corporation’s capital structure. See Malcolm L. Shaw, *The (D) Reorganization - Possibilities and Pitfalls*, 25 SW L.J. 505, 511–12 (1971). In other words, there is an argument over the priority of rights between the creditors and shareholders centering on the rights of shareholders of the newly reorganized corporation. See Douglas G. Baird, *Bankruptcy as a Reflection of the Creditor’s Implicit Bargain*, in CORPORATE BANKRUPTCY: ECONOMIC AND LEGAL PERSPECTIVES 31 (Jagdeep S. Bhandari & Lawrence A. Weiss ed. 1996). Therefore, the main point of the argument is that compensation to creditors should be made according to the issuance of new shares equivalent to the amount of debt. On the other hand, the practice in both Korea and Japan focuses on cash as the means of payment, the repayment period and the rate of discharge of indebtedness of unsecured and secured creditors rather than the rights of shareholders. See Seki, *supra* note 447, at 2–14. Now that the practice is focused on whether the capital structure of a new corporation is reorganized in a fair and equitable manner, the argument has centered on fairness and equitableness rather than feasibility. See 11 U.S.C. § 1129(b)(2) (2012).

However, in both Korea and Japan, it has become a matter of great interest whether making payments on the unsecured claims in accordance with the reorganization plan out of operating profit is feasible rather than its fairness or equitableness. See Stephen H. Case, *Some Confirmed Chapter 11 Plans Fail. So What?*, 47 B.C.L. REV. 59, 60–61 (2005). Therefore, the general public will resent the bankruptcy court if the company fails to carry out the reorganization plan and the corporate reorganization proceeding is terminated midway. See Wilson F. Scott, *Fraud that undermines the bankruptcy system*, 17(5) BUS. L. TODAY, May–June 2008 (reviewing STEPHANIE WICKOUSKI, BANKRUPTCY CRIMES (3d ed. 2007)). Many strongly criticize corporate reorganization law because it protects the previous owner of the corporation at the cost of the creditors. See Yong-Seok Park,

reorganization law, the company's capital shall be equal to the total sum of the par value of all the issued and outstanding shares. The grounds allowing for the efficiency of the no-par-value stock system are furnished naturally.<sup>680</sup>

*D. Debt-for-Equity Swap by Tracking Stocks*

*1. Necessity of Tracking Stock*

In Korea, stock shares are generally defined as common or preferred.<sup>681</sup> While various kinds of stock issuance are acknowledged under U.S. corporate law,<sup>682</sup> the comprehensive notion of common shares and preferred shares does not exist—shares are often treated differently.<sup>683</sup> In this way, the maintenance of the legal infrastructure seems to be a contributing factor to the trend in corporate financial matters towards sensible management.<sup>684</sup>

In the United States, the contents and structure of the classes of common shares carry various forms. The so-called Tracking Stock (TS)<sup>685</sup> and the stock with limited voting rights<sup>686</sup> can be said to be forms of a class of common shares. The TS has been used in many forms since General Motors Company first issued them in 1984.<sup>687</sup> Originally, TS was used in corporate reorganization

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*Efficiency of Korean New Rehabilitation Proceeding*, 7 J. KOR. L. 251, 272, n.50 (2008).

<sup>680</sup> If there is no-par stock assigned in a stated value per share and it is recorded like a par value, the excess of the proceeds over the stated value is treated like a profit. See MINARS, *supra* note 537, at 34. This system is easy to decide the exchange ratio in the Debt-for-Equity swap. See WARREN ET AL., *supra* note 458, at 440.

<sup>681</sup> These are different than the same kind of shares, but unlike the general common shares, which differ in respect to the dividends of profits or interests, or the distribution of the surplus assets. *Types of Stock*, STAYLORDOTROG, [https://saylordotorg.github.io/text\\_foundations-of-business-law-and-the-legal-environment/s25-03-types-of-stock.html](https://saylordotorg.github.io/text_foundations-of-business-law-and-the-legal-environment/s25-03-types-of-stock.html) (last visited April 4, 2017).

<sup>682</sup> See JOHN E. MOYE, *THE LAW OF BUSINESS ORGANIZATIONS*, 377 (1999).

<sup>683</sup> See SOLOMON & PALMITER, *supra* note 679, at 431.

<sup>684</sup> *Id.*

<sup>685</sup> See *Tracking Stock*, INVESTORWORDS, [http://www.investorwords.com/5013/tracking\\_stock.html](http://www.investorwords.com/5013/tracking_stock.html) (last visited Mar. 20, 2017). Shares are issued by a company which pays a dividend determined by the performance of a specific portion of the whole company. *Id.* Tracking stock differs from a spinoff in that it does not represent or require any change in business structure. Holders of tracking stock are considered to hold equity in the parent company and not the specific entity represented by the tracking stock. *Id.* Tracking stock is often set up by companies that have several diverse divisions, both so that investors can take a share in a division of their interest, and so that the performance of these divisions can be tracked in terms of shareholder interest. *Id.* A company will sometimes issue a tracking stock when it has a very successful division that it feels is underappreciated by the market and not fully reflected in the company's stock price. *Id.*

<sup>686</sup> Class stock can be classified by the no-voting-right stock, one-share-to-two voting right stock, or other forms of shares allowed. See MOYE, *supra* note 682, at 377.

<sup>687</sup> See Seungbum Kim, *supra* note 52, at 154–55.

or combination of enterprises.<sup>688</sup>

When a debt-for-equity swap is made for claims, it is attractive for creditors to waive their claims and receive stock issued from a profitable and promising business sector.<sup>689</sup> It is also attractive from the company's standpoint, since its debt problem is solved through the debt-for-equity swap, thus reducing its financial burden and increasing the chance equity capital will be offered.<sup>690</sup>

## 2. *Characteristics of Tracking Stock*

Generally, TS is not issued on the entire business of the issuing company, but refers to the stocks made to track the performance of the target business.<sup>691</sup> Depending on the content, the legal and economical characteristics of TSs are quite different.<sup>692</sup>

As a reason for using TS, when a large, but poor, business prospect company *A* is acquired as a continuing company by company *B*, the acquisition contract may provide that the common shares of company *A* are to be distributed to old shareholders of company *B*. It may be difficult to approve this transaction at the general meeting of shareholders, but it would be easier to obtain this approval if the new shares to be distributed are TSs of company *A* that target company *B* in the interim.

In addition, when a large company *C* has a newly rising business "C-1" (e.g., in the information or genetic technology fields), but the execution of the "C-1" business gets buried under the management duties of the entire business *C* and is not reflected in the stock price of company *C*, company *C* can issue TS targeting "C-1" to reflect "C-1" in the stock price. In this same case, though it means little to offer stock options to directors of company *C*, it would be significant to offer compensation using TSs targeting "C-1."

Importantly, in TS, the stock price of the issuing company is designed to track or reflect the performance of the group, including the particular business or a sister companies, but not the performance of the entire company.<sup>693</sup> Compared to general stock, there are differences in terms of dividends, voting rights, rights

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<sup>688</sup> *Id.*

<sup>689</sup> *Debt to Equity Swaps*, STEP TOE, <http://www.steptoe.com/publications-6418.html> (last visited Mar. 9, 2017).

<sup>690</sup> SEC, *supra* note 619 ("[A] tracking stock must be registered under the Securities Act of 1933 if it is publicly offered.").

<sup>691</sup> See Jeffrey J. Haas, *Directorial Fiduciary Duties in a Tracking Stock Equity Structure: The Need for a Duty of Fairness*, 94 MICH. L. REV. 2089 (1995–1996) (discussing the legal and economical characteristics of tracking stock based on the content).

<sup>692</sup> *Id.*

<sup>693</sup> See Seungbum Kim, *supra* note 52, at 156.

to the remaining assets, and treatment of repayment and conversion. In the United States, TS is issued as a different class of common stock.<sup>694</sup>

Therefore, the TS issuing company gets to issue at least two kinds of common stock. As for voting rights, typically one share of common stock has one vote,<sup>695</sup> but TS computes the number of voting rights per share according to the relative ratio of the stock or the total market price of the target business and non-target business (the market price of the stock multiplied by the total number of outstanding stocks) against a fixed date or a weighted average over a certain period.<sup>696</sup> As for the stock's rights in remaining assets, they are generally computed according to the relative ratio of the total market price of each kind or class of stock at the time right before the liquidation.<sup>697</sup>

Of legal relevance, TS shareholders are not given the direct legal rights over the allotted property of the target business as the target of concerned TS.<sup>698</sup> Instead, they only have a stake in the entire remaining assets of the issuing company in proportion to the number of rights or the size of their holding.<sup>699</sup>

#### *E. Debt-for-Equity Swap by Asset-Backed Securitization*

In the following, we will look into how asset-backed securitization can be put to use in relation to the debt-for-equity swap.

In Korea, financing through the system of Asset-Backed Securitization (ABS)<sup>700</sup> has rapidly increased since the establishment of the Korean Asset-Backed Securitization Act (KABSA) on September 16, 1998. The government wanted to efficiently handle the accumulated nonperforming claims of financial institutions<sup>701</sup> and help the Korea Asset Management Corporation (KAMCO), which had collected a large amount of bad assets from the financial institutions, to quickly collect for the public.<sup>702</sup> While the Act faced initial criticism, it recognizes mainstream acceptance in today's bond market and introduces new se-

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<sup>694</sup> *Can preferred stocks be traded like common stocks? Are their prices the same?*, INVESTOPEDIA, <http://www.investopedia.com/ask/answers/04/071604.asp> (last visited Mar. 20, 2017).

<sup>695</sup> See MOYE, *supra* note 685, at 385.

<sup>696</sup> See Seungbum Kim, *supra* note 52, at 157.

<sup>697</sup> *Id.*

<sup>698</sup> *Id.* at 158.

<sup>699</sup> *Id.*

<sup>700</sup> See Jeffrey B. Tevis, *Asset-Backed Securities: Secondary Market Implications of SEC Rule 144A and Regulation S*, 23 PAC. L.J. 139–40 (1991).

<sup>701</sup> KABSA art. 1.

<sup>702</sup> *Id.*

curities through new designs.<sup>703</sup>

After the Foreign Exchange Crisis in late 1997, the ABS system was introduced in 1998 to promote corporate reorganization.<sup>704</sup> Financial institutions or companies having trouble issuing bonds due to their credit status used the ABS system to increase their financing while coping with the stagnating stock market and the stabilization of the interest rates on company bonds.<sup>705</sup>

In terms of financial restructuring, the ABS is related to both aspects of finance and assets.<sup>706</sup> In terms of asset-backed capital, the ABS is significant as a means of handling bad assets, but if the ultimate goal is to obtain company financing or improvement in financial restructuring, it can be understood as a restructuring tool in the financial dimensions.<sup>707</sup> The credit between the asset holders (originators) and the assets is insulated from the ABS.<sup>708</sup> In other words, as the right of ownership to assets is conveyed to the ABS special purpose company (SPC) from the originators,<sup>709</sup> the investment grade is decided according to the reinforcement of credit and the design of the asset-backed capital structure, even if the credit of the originator is poor.<sup>710</sup> Therefore, the ABS takes the role of supporting a smooth restructuring by providing financing to the restructuring company.<sup>711</sup> In addition, from the standpoint of the restructuring organization that purchases the assets or default claims from financial institutions, the ABS becomes a useful means for selling bad assets.<sup>712</sup>

Under the current system, the role of the ABS in the process of restructuring can be understood through the relationship between originators and asset-backed capital.

First, an originator refers to the one that can create the ABS.<sup>713</sup> Organizations related to restructuring, such as banks, various financial institutions, and KAMCO are designated as originators and use the ABS in the process of financial restructuring.<sup>714</sup> Through a recent amendment of the law, normal companies

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<sup>703</sup> See Seungbum Kim, *supra* note 52, at 165.

<sup>704</sup> KIM CHOONGSOO, FINANCIAL INSTITUTIONS IN KOREA 12 (Lee Sang Woo ed., 2011).

<sup>705</sup> See Seungbum Kim, *supra* note 52, at 165.

<sup>706</sup> See Tevis, *supra* note 700.

<sup>707</sup> See Seungbum Kim, *supra* note 52, at 165–66.

<sup>708</sup> *Id.*

<sup>709</sup> See P. Gifford Carter, Note, *Originator Exposure to Federal Securities Law Liability When Structuring Asset Backed Securities Transaction*, 20 ANN. REV. BANKING L. 272 (2001).

<sup>710</sup> See Seungbum Kim, *supra* note 52, at 166–69.

<sup>711</sup> *Id.*

<sup>712</sup> *Id.*

<sup>713</sup> KABSA art. 2(2)(a).

<sup>714</sup> KABSA art. 2(2)(a)–(r).

have also been designated as originators.<sup>715</sup>

Next, asset-backed capital refers to property rights regarding claims, real estate, and others subject to the ABS.<sup>716</sup> In relation to financial restructuring, the reason asset-backed capital is significant is because bad claims owned by financial institutions and bad claims purchased during the process of financial restructuring by restructuring-related organizations can be disposed of by means of the ABS.<sup>717</sup> In other words, for financial institutions or restructuring-related organizations, ABSs are integral to exit strategies.<sup>718</sup> Bad loans and bonds for banks, investment trust companies, the KAMCO, and restructuring-related organizations are all subject to the ABS.

In Korea, according to the KABSA, the ABS is based on the premise of a true sale; in other words, it involves transfers of ownership rights.<sup>719</sup> In the United States, the right of ownership is not transferred, but synthetic securitization is still in the limelight.<sup>720</sup>

As asset-backed securities become varied, investors' portfolio bases can be expanded.<sup>721</sup> As we look into matters related to the debt-for-equity swap in light of the special features of the ABS, one must specifically recognize that ABSs transfer the status of creditors are capable of expanding the demand base of the debt-for-equity swap, which invite more varied creditors to the review process.<sup>722</sup>

### *1. Notion and Special Features of Asset-Backed Securitization*

The notion of the ABS or securitization can be understood on both theoretical and systematic dimensions.<sup>723</sup>

First, from the theoretical standpoint, the ABS refers to the situation of a security design where the asset pool is made from the combination of various assets and stocks with several classes and priorities being issued.<sup>724</sup> Second,

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<sup>715</sup> *Id.*

<sup>716</sup> See Seungbum Kim, *supra* note 52.

<sup>717</sup> See *id.*

<sup>718</sup> See *id.* at 167–70.

<sup>719</sup> *Id.*

<sup>720</sup> See Jongho Kim, *From Vanilla Swaps to Exotic Credit Derivatives: How to Approach the Interpretation of Credit Events*, 13 FORDHAM J. CORP. & FIN. L. 705 (2008).

<sup>721</sup> See Tevis, *supra* note 700, at 144.

<sup>722</sup> *Id.*

<sup>723</sup> *Id.*

<sup>724</sup> According to one commentator, automobile loans, credit card receivables, and a host of other assets have been packaged as securities and sold by the private sector. See Tevis, *supra* note 700, at 138.



from the systematic or legal standpoint, the ABS refers to a series of actions in which the SPC receives asset-backed assets or asset-backed securities issued as securities from other SPCs or originators, issues asset-backed securities based on them, and pays dividends or the principal of the asset-backed securities using loans or profit from the management, operating assets, or disposal of the asset-backed securities or asset-backed assets of the concerned company.<sup>725</sup> Third, from a policy standpoint, the way to set the range of originators, asset-backed assets, and asset-backed securities becomes an important policy design.<sup>726</sup>

In the meantime, from the security design standpoint, the special features of ABS are as follows. First, in light of cash flow, ABS is significant in that it reconstructs the existing cash flow as a sum of more than two cash flows.<sup>727</sup> Second, in terms of diversifying risk, proper investment in securities can be made according to the risk propensity and risk tolerance ability of the investors, as there are various classes of securities issued through ABS.<sup>728</sup> Third, in terms of information imbalance, as ABS reduces that imbalance, a company with a severe information imbalance problem can receive financing with low capital cost.<sup>729</sup> Fourth, from the standpoint of the right of ownership, the originator's right of ownership on asset-backed assets is transferred to the ABS specialist company.<sup>730</sup> Fifth, in terms of information sensitivity, ABS is a method of security design that increases the information sensitivity of the securities.<sup>731</sup> Sixth, from the regulatory standpoint, financial institutions such as banks can fulfill regulatory conditions such as the BIS ratio by handling bad assets through ABS.<sup>732</sup>

## 2. Classification of Asset-Backed Securitization

A classification of ABSs can be made based on the originators, asset-backed assets, asset-backed securities, subjects carrying out the ABS affairs, and status of the right of ownership.<sup>733</sup> The asset holder can be classified into finan-

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<sup>725</sup> See Seungbum Kim, *supra* note 52, at 166–68.

<sup>726</sup> *Id.*

<sup>727</sup> *Id.*

<sup>728</sup> *Id.*

<sup>729</sup> Stephen Brown, Stephen A. Hillegeist & Kin Lo, *Conference Calls and Information Asymmetry*, 37 J. ACCT. & ECON. 343, 343–46 (2004) (emphasizing the information asymmetry of firms because it is positively related to the cost of equity capital).

<sup>730</sup> See Seungbum Kim, *supra* note 52, at 166–68.

<sup>731</sup> *Id.*

<sup>732</sup> *Id.*

<sup>733</sup> Buchan Yun, *Study on the System of Asset-Backed Securitization*, 6 L. REAL PROP., 125–26 (2000) (S. Kor.).

cial institutions such as banks, KAMCO, liquidating financial institutions under the supervision of official structuring organizations such as the Korea Depository Insurance Corporation, nonofficial restructuring organizations such as the Corporate Restructuring Vehicle (CRV) and Corporate Restructuring Company (CRC), and regular companies.<sup>734</sup>

Under the asset-backed assets standard, ABS can be classified into Collateralized Loan Obligation (CLO), which takes the loan claims as the basic assets;<sup>735</sup> Collateralized Bond Obligation (CBO), which takes the corporate bonds as the basic assets;<sup>736</sup> or Mortgage-Backed Security (MBS), which takes the mortgage loans as the basic assets.<sup>737</sup> The CBO can be further divided into “primary CBO”<sup>738</sup> and “secondary CBO.”<sup>739</sup> Under the asset-backed securities standard, the ABSs are divided into corporate bonds, investment certificates, and beneficiary certificates.<sup>740</sup>

According to their maturity, in the case of asset-backed corporate bonds, ABS is divided into long-term and short-term asset-backed commercial paper (ABCP).<sup>741</sup> According to the interest payment method, it is divided into fixed

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<sup>734</sup> The party with assets subject to asset-backed securitization and the need for asset-backed securitization is referred to an originator and is the practical subject of the asset-backed securitization. See Buchan Yun, *Study on the System of Asset-Backed Securitization*, 6 L. REAL PROP., 125–26 (2000) (S. Kor.).

<sup>735</sup> See Seungbum Kim, *supra* note 52, at 168–69.

<sup>736</sup> *Id.*

<sup>737</sup> *Id.* at 168–70.

<sup>738</sup> The CBOs issued by the SPC (when securities companies take over the total amount of corporate bonds with B–BBB credit ratings and then sell them to the SPC) are different from the CBOs based on the currently circulating corporate bonds in the circulation market. This is a new financial method for financing by sharing the risk when it is difficult for individual companies themselves to issue corporate bonds due to their low credit rating. See Sangche Lee & Jung-Han Koo, *New Financial Products and Their Impact on the Asian Financial Markets*, S. KOR. INST. FIN. 26–32 (Mar. 2009), <http://www.asean.org/storage/images/archive/documents/ASEAN+3RG/0809/FR/15a.pdf>.

<sup>739</sup> After transferring the corporate bonds which are still circulating to the SPC, the SPC issues ABS bonds based on those corporate bonds. See MOORAD CHOUDHRY, *THE BOND AND MONEY MARKETS: STRATEGY, TRADING, ANALYSIS* 468–69 (Butterworth-Heinemann 2001).

<sup>740</sup> David A. Hall et al., *Asset-Backed Securities (ABSs)*, 16 REC. SOC’Y ACTUARIES 973, 973–1009 (1990).

<sup>741</sup> See Rob Davies, *International ABS Issuance on the Rise in Korea*, FIN. ASIA (Oct. 26, 2001), <http://www.financeasia.com/News/32251,international-abs-issuance-on-the-rise-in-korea.aspx#>.

Bond-type ABSs issued based on short-term notes such as credit card debt acquired by a SPC are similar to other standard companies. *Id.* But other than the maturity of the securities being the shortest, it has significance in that it supplements part of the ABS redemption money by issuing short-term commercial paper. *Id.* In Korea, LG Capital first issued KRW 502.7 billion worth of securities on August 21, 2000. *Id.*

and variable interest-bearing, asset-backed floating rate notes (ABFRN).<sup>742</sup>

Under the standard of ownership status transfer, it can be classified into asset-backed securitization that is based on the actual transfer of asset-backed assets and synthetic securitization, where only the cash flow is transferred without actual transfer of the right of ownership.<sup>743</sup>

The subjects of the asset-backed securitization business in Korea are SPC and trust companies, including banks combined with the trust business through the Trust Business Act.<sup>744</sup>

### 3. Plans for Activation of Asset-Backed Securitization

The core issue in designing financial products in ABS is how to devise ones that can satisfy the different desires of both investors and companies. In the case of ABS, in order to better satisfy the desires of investors and insolvent companies, thorough, preparatory research on the investors and company is necessary.<sup>745</sup> However, during the recent economic slump, the credit risk increased and investors tended to become more risk averse.<sup>746</sup>

In this situation, the ABS plan must be made to reduce credit risk as much as possible through credit enhancement and shortening of maturity.<sup>747</sup> In addition to external credit enhancement, internal credit enhancement systematically guarantees the return of principal.<sup>748</sup>

In the latter case, the most frequently used “unsubordinated and subordinated debt” system grants priority to general investors when the principal is being paid.<sup>749</sup> It is a method that secures the financial resources for repayment for the unsubordinated creditors by transferring the subordinated debt that can cause the burden of risk of loss due to the lack of repayment capacity by the SPV to originators.<sup>750</sup> Other methods are also used such as requiring the cash flow from the assets subject to securitization to be more than the return amount of principal of asset-backed securities and calling for the deposit (cash securities) in securi-

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<sup>742</sup> See Seungbum Kim, *supra* note 52, at 169–70.

<sup>743</sup> *Id.*

<sup>744</sup> *Id.*; see also Lusina Ho & Rebecca Lee, *Trust Law in Asian Civil Law Jurisdictions: A Comparative Analysis*, CAMBRIDGE UNIV. PRESS, 2013, at 105–10.

<sup>745</sup> 15 U.S.C.A. § 780–11; see also Seungbum Kim, *supra* note 52, at 171–72.

<sup>746</sup> INTERNATIONAL MONETARY FUND, GLOBAL FINANCIAL STABILITY REPORT: GRAPPLING WITH CRISIS LEGACIES 81 (Sept. 2011).

<sup>747</sup> See Seungbum Kim, *supra* note 52, at 171–72; see also S.E.C. No-Action Letter, Investment Company Institute, 2010 WL 3161926 (Aug. 10, 2010).

<sup>748</sup> See Seungbum Kim, *supra* note 52, at 171–72.

<sup>749</sup> *Id.*

<sup>750</sup> *Id.*

ties for the cash exceeding a certain amount in the escrow account and the accumulated reserves (internal reserves) at a SPV.<sup>751</sup>

In devising the ABS structure,<sup>752</sup> the typical planning factors include the design of asset-backed assets, the underlying asset, and the securities issued for the investors (i.e., the designing of asset-backed securities, the methods for preserving credit, and the decisions on the status of the rights' ownership).<sup>753</sup>

First, asset-backed assets must be diversified.<sup>754</sup> The ability to develop creative products such as the CBO or the CLO in particular, where there is pooling of asset-backed assets, necessitates a reduction in risk.<sup>755</sup> Second, the designing of asset-backed securities must reflect the special features of investors or asset-backed assets.<sup>756</sup> As uncertainty regarding long-term claims becomes greater during such times as the recent economic depression and bear markets, it is necessary to shorten the expiration on claims such as ABCP.<sup>757</sup> Third, the methods for maintaining credit must be diversified.<sup>758</sup> Lastly, it is good to use synthetic securitization that does not involve the transfer of the right of ownership.

## VIII. CONCLUSION

The biggest problem the Korean economy faced under the IMF manage-

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<sup>751</sup> *Id.*

<sup>752</sup> See S.E.C. No-Action Letter, *Distribution of Certain Written Materials Relating to Asset-Backed Securities*, Fed. Sec. L. Rep. P 77, 1995 WL 67338 (“[The information derived from registration statements] is provided to a prospective investor, generally at such investor’s request, in order to assist the prospective investor in determining whether a proposed structure for an ABS offering will meet such investor’s needs.”). *Id.*

<sup>753</sup> See Seungbum Kim, *supra* note 52, at 171–72.

<sup>754</sup> In a press release, the Korean Financial Supervisory Service (KFSS) addressed the notable features of the Korean ABS market. See Press Release, Korean Financial Supervisory Service, Review on the Issuance Results on ABS (Feb. 26, 2002). ABS emerged as a new window to financing for standard companies while the range of asset-backed assets also sharply expanded. *Id.* The total issuance amount (33 cases, KRW 4.1 trillion) of ABS based on future trade receivables increased by 4.5 times as compared to the previous year (8 cases, KRW 0.9 trillion) and along with the increase of ABS market advance, asset-backed assets also diversified in such fields as loans and other credit card receivables such as air fares, passenger and freight payments; receivables on steel, oil, and tires; fees for internet service; payment for building sales and construction; hotel room rates; and subscription fees for terminals. *Id.* In addition, as the use of credit cards soared, credit card sale receivables (cash service receivable included) as well as credit card ABS (KRW 20.6 trillion) that were issued based on the credit card loans increased by more than five times compared to the previous year (KRW 4.0 trillion). *Id.* Thus, credit card ABSs became mainstream in the Korean ABS market. *Id.*

<sup>755</sup> See Seungbum Kim, *supra* note 52, at 171–72.

<sup>756</sup> *Id.*

<sup>757</sup> *Id.*

<sup>758</sup> *Id.*

ment system was the easing of tight credit and the promotion of the capacity for the redemption of debts, both domestic and foreign, by preparing the foundation for long-term growth and fostering the environment for survival of insolvent companies through corporate financial restructuring. Particularly in certain situations, excess debts due to poor leverage management needed to be reduced and the corresponding capital needed to be secured.

However, it was difficult in the fragile capital market, under the stagnating economy, to find the users to take over the assets of companies or to finance a large amount of capital to reduce debt. Under such adverse circumstances, the risk of company insolvency and bankruptcy increased as a result of excess financial costs and the reduced equity capital of financial institutions having accumulated bad loan claims. At the same time, the vicious economic circle continued as the ability to make loans weakened, resulting in the aggravated credit crunch.

The debt-for-equity swap seemed like a practical way for ailing companies with bad loan claims to survive the economic crisis. Under a debt-for-equity swap, financial institutions' statuses as creditors changed to shareholder. Their priority order for repayment became lower, but they no longer needed to make interest payments on loans.

By participating in the shares of the company, new shareholders could exercise their management rights and, if the price of stock went up, realize profits on investments at a higher rate of return than those enjoyed from interest on loans. Meanwhile, from the company's standpoint, the debt was reduced and the equity capital is increased, resulting in a more sound financial structure. On the other hand, the stake ratio of the existing shareholders was reduced by the debt-for-equity swap portion of the financial institutions.

Although there is no direct provision in the KCA regarding debt-for-equity swaps, they can be summarized as an attempt at theoretical legal construction (securitization of debt) by borrowing from the system of in-kind investment or finding an exception in the theory that prohibits the subscription price payment by set-off. In the former case, the transferred claims through the in-kind investment will expire, mixed with the obligations, and only get recorded as capital on the balance sheet of the company. In the latter case, a new interpretation of Article 334 of the KCA can be attempted, which uses the set-off contract by emphasizing the purpose and history of Article 334 rather than making a direct theoretical construction.

However, the purpose of prohibiting the set-off on the amount of the subscription price payment was to prevent set-offs from being used by companies against the issuance of stock as a means of financing. The same provision cannot be directly applied to a debt-for-equity swap that is not prearranged for financing from the beginning, and when an exception to the prohibition of the

subscription price payment by set-off is permitted, the KCA stipulates that it could result in the dismantling of capital adequacy. Arguably, it becomes ambiguous to apply the exception of Article 334 of the KCA to a particular company.

If a theoretical construction is made according to par value theory after adoption of the in-kind investment method, it seems unreasonable to devise a legal construction regarding the debt-for-equity swap that would intentionally create an exception to the prohibition of the subscription price payment by set-off if the procedure and time necessary for the evaluation of the market price of claims by the court-appointed investigators can be handled with ease.

## APPENDIX

[Table 1] Fund-Raising and Other Financial Facts Comparison at the Time of Asian Financial Crisis (Unit: %)

Category	Tai- wan (1995)	Korea					Japan (1998)	U.S. (1999)
		1990- 1999	1997	1998	1999	Jun. 2000		
Rate of depend- ence on loan (1)	25	47	54	51	43	41	34	28
Rate of liabilities (2)	86	302	396	303	215	193	174	164
Interest coverage ratio (3)	—	1.13	1.29	0.68	0.96	1.69	2.92	3.54

(1)  $(\text{Loan} + \text{Bond}) / \text{Total Capital} \times 100$ (2)  $(\text{Liabilities} / \text{Paid-in Capital}) \times 100$ (3)  $(\text{Operating Profit} / \text{Interest Cost})$ 

[Table 2] Balance Sheet before Debt-for-Equity Swap

Assets	500	Loans	300
		Other Obligations	200
		Capital Deficit Carried Forward	50 ▲ 50
Total	500	Total	500

[Table 3] Balance Sheet after Debt-for-Equity Swap

Assets	500	Loans	200
		Other Obligations	200
		Capital	100
		Capital Surplus Reserve	50
		Deficit Carried Forward	▲ 50
Total	500	Total	500

[Table 4] Changes in Mexican Companies' Possession before and after the Foreign Currency Crisis

	Family	Foreign Investors	General Investors	Government, etc.
Foreign Currency Crisis (1982)	80%	15%	2%	3%
1996	49.5%	35.2%	3.1%	11.2%

[Table 5] Labor Indexes before and after the 1994 Foreign Currency Crisis

	1992	1993	1994	1995	1996	1997
Actual Wage Increment	9.8	4.9	3.7	-13.5	-11.1	-0.6
Minimum Wage Fluctuation	0.0	8.3	6.9	17.6	24.1	14.3
Unemployment Rate in Urban Areas	2.8	3.4	3.7	6.2	5.5	3.7
New Worker Increment	-	-	-3.0	-9.0	2.4	4.9

[Table 6] Change of Capital Structure in Morrison Knudsen

	December 31, 1994 before Restructuring	
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	Accounting Value	Market Value	
Total Asset	\$1,273M	\$1,090M *	Market value is lower than accounting book value
Non-financial Debts	\$973M	\$973M	
Net Asset	\$300M	\$117M	
Loans	\$242M	\$242M	
Contingent Liabilities	-\$150M *		Off-the-book loans (LC-related)
Total	\$242M	\$392M	
Capital	\$58M *	(\$275M)	Default (Insolvency)
Collectable Value of Debts	\$242M	\$117M *	Equal to net asset price
Collection rate (%) *	-30% **		Market value of financial debts  It is collectable liability out of total financial debt

	June 30, 1995		
	Accounting Value	Market Value	
Total Asset	\$1,063M	\$947M	
Non-financial Debts	\$750M *	\$750M	Market value decreased by USD 223 Million at the end of 1994
Net Asset	\$313M	\$197M *	Market value increased by USD 8 Million compared to the end of 1994
Loans	\$225M *	\$225M	Decreased by USD 17 Million compared to the end of 1994 by overdraft repayment
Contingent Liabilities	-\$150M		
Bridge Loan	\$84M *	\$84M	1st loan among USD

			0.11 billion
Total	\$309M	\$459M	
Capital	\$4M	(\$242M) *	A slight change in market value at the end of 1994

	December 31, 1995		
	Accounting Value	Market Value	
Total Asset	\$628M *	\$718M	Accounting value decreased by USD 435 Million at the end of June 1995 as the train division is detached
Non-financial Debts	\$571M *	\$571M	Decreased by USD 179 Million
Net Asset	\$57M *	\$147M	Accounting value decreased by USD 256 Million and Market value decreased by USD 50 Million
Loans	\$213M *	\$213M	A slight decrease by selling assets
Contingent Liabilities	-\$150M		
Bridge Loan	\$38M *	\$38M	1st repaid and 2nd newly issued
Total	\$251M	\$401M	
Capital	\$194M	(\$254M)	

	May 31, 1996		
	Accounting Value	Market Value	
Total Asset	\$494M *	\$494M	Accounting value decreased by USD 134 Million compared with December 31, 1995
Non-financial	\$302M	\$302M	

Debts			
Net Asset	\$192M	\$200M	
Loans	0 *	0	All loans converted into capital
Contingent Liabilities	0	0	
Bridge Loan	0	0	
Total			
Preferred Stocks	\$18M *	\$18M	Tax return was converted into securities
	\$174M	(\$182M) *	Market value after restructure was larger than accounting capital

	November 30, 1996		
	Accounting Value	Market Value	
Total Asset	\$840M *	\$1,066M	50% each for MK and Washington.
Non-financial Debts	\$510M	\$510M	
Net Asset	\$330M *	\$556M	40% for MK and 60% for Washington.
Loans	0	0	
Contingent Liabilities	0 *	0	All loans converted into capital.
Bridge Loan	0	0	
Total	0	0	
Preferred Stocks	\$18M *	\$18M	Given to existing MK creditors
Ordinary Stocks	\$312M *	\$538M	45% given to MK creditors